TEESSIDE PENSION FUND & INVESTMENT PANEL

A meeting of the Teesside Pension Fund & Investment Panel was held on 9 March 2016.

PRESENT: Councillors S E Bloundele (Chair); J Rostron (Vice-Chair); R Brady, J G Cole, D P Coupe, G Purvis and J Rathmell

Other Local Authority Members:

J Lindridge - Hartlepool Council

ALSO IN ATTENDANCE: Auditors - Ernst Young: D Houghton and N Wright
Investment Advisors: F Green and P Moon
Property Advisors: A Martin and A Owen
Unison: A Watson

OFFICERS: P Campbell, B Carr, G Hall and A Hill

APOLOGIES FOR ABSENCE Councillor J Beall, Councillor J Culley, Councillor N Hussain, Councillor D McCabe, Councillor A Shan, P Fleck.

DECLARATIONS OF INTERESTS

Name of Member	Type of Interest	Item/Nature of Interest
Councillor Bob Brady	Non-Pecuniary	Member of Teesside Pension Fund
Councillor J Lindridge	Non-Pecuniary	Member of Teesside Pension Fund
Councillor J Rostron	Non-Pecuniary	Member of Teesside Pension Fund

1 MINUTES - TEESSIDE PENSION FUND AND INVESTMENT PANEL - 9 DECEMBER 2015 AND 9 FEBRUARY 2016

The minutes of the meetings of the Teesside Pension Fund and Investment Panel held on 9 December 2015 and 9 February 2016 were taken as read and approved as a correct record.

2 FUND MANAGER'S REPORT (INCLUDING TRANSACTION REPORT AND CUSTODIAN VALUATION)

The Chief Finance Officer submitted a report to inform Members with regard to: (i) how the Investment Advisors' recommendations outlined at the meeting held on 9 December 2015, were being implemented; (ii) to provide information with regard to stock selection strategies, including a detailed report on transactions undertaken (Appendix A); and (iii) to present an independently produced valuation of the Fund's assets (Appendix B).

The report provided a summary of the advice received from the two Investment Advisors at the previous meeting of the Panel held on 9 December 2015. The Panel was advised that the USA had raised interest rates, as anticipated. It had been a good quarter for the equity markets, particularly in relation to the USA and Japan.

The Panel was advised that there was net disinvestment of approximately £3m in the period, compared to net disinvestment of £66m in the previous reporting period. Cash balances had increased from £132m to £150m. The Panel was provided with a summary of each of the Fund's asset classes.

The Fund Valuation, attached at Appendix B to the report, prepared by the Fund's custodian BNP including the total value of all investments including cash was valued as at 31 December 2015 at £3,085 million, compared to the last reported valuation of £2,938 million as at 30 September 2015.

An analysis of the summary valuation provided a comparison between the Fund's weightings in the various asset classes, compared with the Fund's customised benchmark and the average of other funds, and was set out in a table in paragraph 6.2 of the report.

ORDERED that the report be noted.

3 **INVESTMENT ADVISORS REPORT**

The Investment Advisors each gave their views on the current global economic, political and market conditions, and reviewed the current position of the Fund. They drew Members attention to the current volatility in asset, commodity and currency markets and both expect this to continue given the news-flow surrounding next week's UK Budget Statement, the EU referendum in June, the US elections later this year, the continued threat from ISIS and the on-going refugee crisis in Europe.

Both Advisors explained that markets do not like uncertainty, which explains the volatility in markets, but this should be used to the Fund's advantage with opportunities to purchase assets when values are low, and reduce investment when markets rally.

In discussing the short term asset allocation, both Advisors acknowledged the current allocation compared to both the customised benchmark and other Funds' allocations. Their general view is to carry on with the allocation strategy set at the previous Panel meetings with growth assets preferred over protection assets.

The Advisors stated that if equity markets weakened, this is an opportunity to invest further in equities on a company specific basis. If equity markets strengthened, this is an opportunity to reduce the equity allocation. In the current environment, the Advisors agreed suitable target allocations for UK Equities and Overseas Equities of 35% and 45% respectively, with a wide range of a 3% either side of these targets to allow advantage to be taken of expected equity market volatility.

The property portfolio should continue to be managed and increased where opportunities allow, after giving regard to location, the quality of the tenant and seeking a good yield. Given the current property market conditions and the recent increased asset allocation to property, the Advisors thought now is an appropriate time to seek a higher yield target of approximately half a percent for any future purchases.

The Advisors suggested an asset allocation range between 6% and 9% was appropriate for property given the current market conditions and allowed further room to add to the existing property portfolio should suitable investment opportunities arise.

In respect of Alternative Investments, the Advisors both commented on the UK Chancellor's recent statements regarding UK infrastructure and the proposed use of the Local Government Pension Scheme being considered in the current reforms. Both Advisors continue to hold the view that Alternative Investments, particularly infrastructure, absolute return investments and taking pricing opportunities in the commodity markets are attractive to the Fund. Investment in this asset class is appropriate where the investment provides the Fund with diversification at a reasonable cost. The Advisors suggested an asset allocation of between 2% and 4% to allow future opportunities in this class be taken.

Both Advisors expressed growing concern over the general state of the global economy, and explained that monetary policy using quantitative easing does not work all of the time. They also explained that the moves to negative interest rates by some territories only creates more uncertainty and put downward pressure on bond yields. Previous comments were reiterated where the Advisors would be happy to see a reduction in bonds, even from the current low levels, and the Advisors suggest a current asset allocation range of 0% to 3%. Both Advisors continued to stress that bond yields at current levels do not meet the Fund's actuarial obligations.

Both Advisors agreed that the current market volatility and the Fund's strategy could lead to cash levels oscillating between uncomfortably high and uncomfortably low levels. They suggested a wide short term asset allocation range for cash of between 3% and 10% to facilitate this strategy.

Finally, the Advisors asked for an investigation into whether it is practically possible for the Fund to hold some cash in alternative currencies, for example US Dollars, over the EU Referendum as concern was expressed about a possible devaluation of the Pound and holding alternative currencies would allow future purchases of foreign assets at exchange rates which are expected to be more favourable before the referendum than rates afterwards. If it is practically possible to hold cash in alternative currencies, the Advisors would like the Fund to make the exchange providing the exchange rates are favourable and the opportunity presents itself.

4 **CBRE PROPERTY REPORT**

The Fund's Property Advisors submitted a report that provided an overview of the current property market and informed Members of individual property transactions relating to the Fund.

The Panel was advised that in London, investment activity had been driven by overseas investment and compared to other cities some overseas investors felt that property in London was currently over-priced.

As a general comment, the European Real Estate offered better value than the UK market. As the UK market had peaked, the European market had caught up. The UK market however was much more predictable and slower in trends. There had been increased activity in the UK provincial markets and the Real Estate markets were affected by the Equity markets. There was also increased interest in defensive Real Estate. It was highlighted that Ground rent income produced real return over a longer period of time. There had also been a lot of interest in the provision of debt as a long term product.

The IPD Quarterly All Property Total Return Index was 13.1% for 2015, with the office and industrial sectors registering almost identical total returns. The Teesside Pension Fund Direct Property Portfolio outperformed this Index, with a Total Return of 14.9% for 2015. UK Total Returns going forward to 2019 were expected be low at 3% and further slowing to 0.9% in 2020. However, in terms of 5 year annualised total returns, Industrials were forecast to perform the best when compared to other sectors, registering 9.5% growth per annum from 2016 - 2020. Office yields were expected to be slower and produce a negligible yield shift for the period 2016 - 2020.

Central London yields were expected to have a limited yield compression, however sustained economic activity was expected to boost South East offices performance but this was not sufficient to significantly increase overall office performance over the 5 year forecasts.

In terms of how the European Referendum might affect the property market, the Panel was advised that when the Scottish referendum was held, transactions markets slowed in the period up to the vote but evened out over the following twelve months.

The Panel was advised that the Fund did not invest heavily in offices as the investment tended to decrease over time and the inherent depreciation was often not fully reflected in the pricing of offices. Therefore, these should only be considered on a more opportunistic basis. The Property Managers advise the Fund invest in well-located, secure industrial and retail assets. The Panel received an analysis of the income forecast and current rental growth projections.

At 31 December 2015, the Fund's property portfolio comprised of 23 mixed use properties located throughout the UK with a value of £175.2. This reflected an overall Net Initial Yield of 5.28% and an Equivalent Yield of 5.43%.

It was highlighted that the total arrears, excluding the CRS insolvency debt situation and those occupiers paying rent monthly, had been reduced to £38,000 spread over 27 tenancies, since the report had been produced. All debts continue to be chased for payment.

ORDERED that the report be noted.

5 **BUSINESS PLAN**

The Panel considered a report submitted by the Chief Finance Officer the purpose of which was to present the Annual Business Plan for 2016/17 in relation to the Fund.

The Business Plan had been updated to include:-

- An Annual Report to Council (included at Page 17 of the report);
- A revised Annual Plan for key decisions (included at Page 15 of the report); and
- Estimated outturn for 2015/2016 for the management expenses budget and proposed budget for 2016/2017

The following aspects of the report were highlighted:-

- Management Expenses Budget - Page 12 of the report; and
- Budget and expected out-turn - Page 13 of the report

The Panel was advised that there was expected to be an Underspend in respect of the following:

- External Fees (Withholding Tax) - these fees would only be paid after successful court appeals to reclaim withheld tax from dividend payments;
- Information Systems - The budget included provision for an additional Bloomberg system, which at present had not been required.

There was expected to be an Overspend in respect of External Fees. This reflected the increase in activity in property over the year, and the growth in the Fund's property portfolio.

The Panel was advised that a number of reviews and reports had been scheduled as a result of previous Panel decisions and the requirement to put out to external tender some of the services provided to the Fund. It was highlighted that it could be necessary to delay non-contractual elements of the Plan, depending on the resources available.

The Work Plan for 2016/2017 was as follows:-

- Final Submission for Pooling Assets
- Outcome of the Actuarial Valuation of the Fund;
- Investment Strategy Statement (replacement for the Statement of Investment Principles);
- Tender for Legal Services relating to the Fund's Property Portfolio;
- Tender for Shareholder Governance;
- Tender for Property Investment and Agent Services (option for 1 year contract extension).

The Work Plan for 2017/2018 was as follows:-

- Tender for Global Custodian (option for 1 year contract extension);
- Review of Investment Advisor Arrangements.

It was suggested that the review of the Investment Advisor arrangements be delayed for a few years as the Final Submission of the Pooling Assets and the Actuarial Review would take time.

ORDERED that the Business Plan and the Annual Report for Teesside Pension Fund for 2016/2017, be approved.

6 **MIFIR & MIFID II**

The Chief Finance Officer submitted a report, the purpose of which was to inform Members of the Panel of the Markets in Financial Instruments Regulations (MiFIR) and Directive II (MiFID II) and its impact of Teesside Pension Fund.

The Head of Investments and Treasury Management advised that MiFID was introduced in 2004 with an implementation date of 1 November 2007, in order to improve the efficiency and effectiveness of stock markets. The expected benefits following the introduction of MiFID had not flowed equally to all of the market participants, in particular, according to the European Commission, these benefits were not always passed on to the end investor.

The trading environment had become more complex and fragmented and the financial crisis had highlighted weaknesses in the regulation of instruments (other than shares) traded mainly between professional investors (i.e. derivatives).

MiFID II which repealed Directive 2004/39/EC and MiFIR were published in the Official Journal of the European Union on 12 June 2014. The new rules would be applicable from January 2017.

It was highlighted that MiFIR/MiFID II was split into two different pieces of legislation which consisted of a Directive and a Regulation. The Directive allowed member states some flexibility in transposing to local law, whereas the Regulations were binding on and took direct effect in all member states.

The new Directive/Regulations impacted on the Fund in three different ways;-

- Client Classification - imposed stricter provisions for public sector entities;
- Inducements - imposed restrictions on provision of free of charge research to clients; and
- Recording of Communications - increased records retention period to 5 years.

In terms of Client Classification, previously some discretion was left with the broker/regulated financial institution and client to decide on the most appropriate client classification. This allowed the Fund as a professional client, to trade fully without restrictions and without regulation.

Under MiFID II, clients could be classed as Per Se Professional (which meant that the client had to have experience but did not need to be regulated), Eligible Counterparty or Retail Clients. It was highlighted that all Pension Funds managed and operated as part of a local authority would be classified as Retail Clients. A Pension Fund operated as a separate legal entity, but owned by a Local Authority could be classified as a Per Se Professional or an Eligible Counterparty.

Local Authorities could still be allowed to Opt Up to Elective Professional, however this would be at the discretion of Individual Member States (including which criteria would need to be met in order to Opt Up). It was highlighted that Elective Professionals would be prevented from Opting Up to Elective Eligible Counterparty.

The Panel was advised that the Financial Conduct Authority (FCA) as the UK's financial regulator would determine the final Opt Up criteria. The FCA was currently considering three options:

- Option 1 - Meet 2 out of 3 criteria;
- Option 2 - Either make all 3 criteria under Option 1 mandatory or increase the minimum size of portfolio to EUR 10 million;
- Option 3 Require Local Authorities to meet 2 out of the 3 current large undertakings criteria.

Details of the criteria in respect of each of the options were included within the report. A copy of a Briefing paper produced by the Local Government Association (LGA) regarding MiFID II was attached at Appendix A to the report. It was highlighted that the briefing paper was more applicable to externally managed Funds; however it included details of the next steps that the LGA were looking to take.

In terms of Inducements, it was highlighted that the TPF currently paid a commission to brokers for each trade and in return, received an execution of the trade. Some of those brokers provided investment research from Analysts and Commentators and consequently, the Fund did not make a direct payment for the research as the fee was included with the commission rate for each trade.

The European Securities and Markets Authority (ESMA) had been looking into how firms used dealing commission i.e. the charges paid when investment managers executed trades and acquired external research on their behalf. ESMA had subsequently proposed that investment manager's payments for research should be separated from execution arrangements. Brokers providing both execution and research services to investment managers were required to identify a separate fee for the execution service, with research charges charged for separately and not influenced by levels of payment received for execution. Any surplus would either have to be rebated or offset against future budgets.

Currently all FCA regulated financial institutions were required to record all telephone conversations and electronic communications however as the TPF was not regulated there was no system in place to do this, particularly in relation to those associated with trading orders. The introduction of MiFID II reinforced the need for effective recording of all communication and lengthened the period of retention of such records to five years.

The Teesside Pension Fund Managers had approached the Fund's Custodian (BNP Paribas Securities Services) and the Fund's Property Manager (CBRE) to arrange to discuss their criteria under MiFID II to Opt up to Eligible Professional Classification. The TPF also intended to seek advice from The Council's Commissioning Team regarding the options for paying for research and how it would fit in with the Council's Procurement Policy. They also intended to carry out research with regard to the requirement to record all communications and discuss the options with the Council's Information and Communication Technology Team.

ORDERED as follows:

1. That the report be noted.

2. That news flow be continued to be monitored and that the Members of the TPFIP be kept informed of any further developments.

7 **TREASURY MANAGEMENT REPORT**

A report by the Chief Finance Officer was submitted, which included detail of the management of the Fund's cash balances, including the methodology used.

The counterparty list and associated limits as at 31 December 2015 was detailed at paragraph 6.1 of the submitted report.

As at 31 December 2015, the Fund had £136.0m invested with approved counterparties at an average rate of 0.478%. A graph attached at Appendix A to the report showed the maturity profile of cash invested and the average rate of interest obtained on the investments for each time period. As an example, 15.14% of the Fund's cash investments were repayable in the period 2 weeks to 1 month at an average interest rate of 0.400%.

ORDERED that the report be noted.

8 **PERSONAL SHARE DEALING**

The Chief Finance Officer submitted a report in accordance with the Management Agreement to inform Members of personal share dealing activity.

Members were advised that as part of the requirements of the Management Agreement officers were required to report all personal share dealings to the Head of Investments and Treasury Management, who was responsible for maintaining the Register for such dealings. The following transactions had been undertaken:

- 8 December 2015 - 100 Centrica shares;
- 8 December 2015 - 10 Roche shares;
- 14 December 2015 - 100 Vodaphone shares;
- 3 February 2016 - 5 Roche shares.

In accordance with the above agreement the purchases of the shares had been reported to the Head of Investments and Treasury Management.

ORDERED that the report be noted.

9 **EY LLP EXTERNAL AUDIT PLAN**

The Fund's Auditors, Ernst and Young LLP submitted their Audit Planning Report which set out how they intended to carry out their responsibilities as the Fund's external auditor.

The report summarised the Auditor's preliminary assessment of the key risks driving the development of an effective audit for the Fund and outlined their planned audit strategy in response to those risks.

The scope of the Audit was outlined at Page 7 of the report. A timetable showing the key stages of the audit was outlined at Page 8 of the report. The timetable included the deliverables that the auditor had agreed to provide to those responsible for governance through the Teesside Pension Fund and Investment Panel for the 2015/2016 accounts.

The auditor also agreed to provide the Panel with and significant real-time control issues and observations as identified. The report to the Panel would contain practical business insights, updates on corporate governance and regulatory matters.

Following the conclusion of the audit, an Annual Audit letter would be prepared by the auditor, to communicate the key issues arising from the auditor's work to the Fund and external stakeholders, including members of the public.

ORDERED that the Audit Planning Report be noted.

10 **POOLING UPDATE**

The Chief Finance Officer submitted a report, the purpose of which was to follow up on the report of the LGPS Investment Reform presented at the previous meeting of the Panel held on 9 February 2016, and the joint proposal submitted to the Department for Communities and Local Government (DCLG).

The Panel was advised that the DCLG's reform criteria was as follows:-

- Asset pools achieve the benefits of scale - Pools should be £25 billion as a minimum;
- Strong governance and decision making - Pools need to be capable of managing investments and risk on behalf of Funds;
- Reduced cost and excellent value for money, i.e. saving must be made across the LGPS;
- Improved capacity to invest in infrastructure - This is implied with the pools having greater scale than single Funds.

A report had been presented to the Panel meeting held on 9 February 2016, and Members agreed to partner with the Borders to Coast Pension Partnership (BCCP) pool. It was also agreed at that meeting that the Teesside Pension Fund would submit the BCCP initial proposal (which was attached at Appendix B) to the DCLG. The proposal was submitted on 19 February 2016.

ORDERED as follows:-

1. That Members note the attached presentation (Appendix A) and the initial proposal by Borders to Coast Pension Partnership (BCPP), submitted to the DCLG (attached at Appendix B).

2. That Members be kept informed of progress towards the final, completed pooling proposal to be submitted to the DCLG in July 2016.