PENSIONS PARTNERSHIP

BCPP Joint Committee

Date of Meeting: **1 October 2020**

Report Title: **Annual review of Overseas Developed Markets Equity Fund (for information and discussion)**

Report Sponsor: **Border to Coast CIO – Daniel Booth**

1 Executive Summary

1.1 The annual review of the Overseas Developed Markets Equity Fund has been performed in line with the Border to Coast Product Development and Review Policy.

1.2 The review includes performance and risk profile; the suitability of the benchmark; the appropriateness of the portfolio structure and portfolio construction; and whether customer requirements are being met.

1.3 The key points to note are:

- The performance of the Overseas Developed sub-fund has exceeded the target in both the last year and since inception and is attractive in risk-adjusted terms.
- The risk profile of the sub-fund has increased but remains at the lower end of the indicative range. This is despite the risk profiles of the individual portfolios being closer to the middle or top end of the range.
- The benchmarks are considered to be appropriate. The previous annual review discussed the suitability of the benchmark for Pacific ex-Japan due to the presence of South Korea (which can also be classified as an emerging market). As the current benchmark for the Emerging Markets Hybrid fund is FTSE Emerging Markets (which does not include South Korea) the benchmark is considered appropriate for those Partner Funds that have invested in both sub-funds.
- There have been four rebalancing exercises during the year to re-align country allocations. A new rebalancing methodology was implemented in June 2020 to more closely align re-balancing with relative benchmark movements.
- Additional resources in Research have provided support to the Portfolio Managers and will aid longer term succession planning.
- There has been a significant reduction in the number of holdings, an area highlighted in the last annual review, in order to increase both active risk and active share. Whilst this has served to increase the tracking errors and active share of the individual portfolios it has had less of an impact at the sub-fund level.
- The potential to develop the sub-fund was discussed with investors during 2019. It was agreed to delay further consideration to allow time for the portfolio managers to adjust to their transfer to Border to Coast. This will be revisited in due course.

- No substantive changes to the sub-fund are considered necessary following the annual review.

2 Recommendation

2.1 That the report is noted.

3 Overseas Developed Markets Sub-Fund

Performance

3.1 The sub-fund (current AUM of **£3.0bn**) has out-performed the benchmark in the last year and since inception with stronger relative performance in Pacific ex-Japan and US and weaker performance in Europe ex-UK:

Overseas Developed Markets	1 year	Since inception
Sub-fund	5.1%	5.7%
Benchmark	3.5%	4.5%
Relative	1.6%	1.2%
US	*+2.4%*	*+1.5%*
Europe ex-UK	*-0.2%*	*+0.3%*
Pacific ex-Japan	*+3.1%*	*+2.2%*
Japan	*+0.8%*	*+1.1%*

Annualised returns as at 30 June 2020

3.2 The sub-fund receives a beneficial tax treatment relative to standard withholding tax rates used in calculating net benchmark returns. It is estimated that c. 30% (c. 0.35% p.a. since inception) of the out-performance is due to the beneficial tax treatment. Around half of this benefit occurs in the US portfolio, with the remainder broadly spread across the European and Pacific portfolios with minimal impact on Japan.

3.3 Using an MSCI World (ex-UK) benchmark, the sub-fund has performed in line with the peer group over the last year but has underperformed on both an absolute and risk-adjusted basis since inception.

Overseas Developed Markets (percentile ranking)	**1 year**	**Since inception**
Relative performance	50th	66th
Information ratio	49th	61st

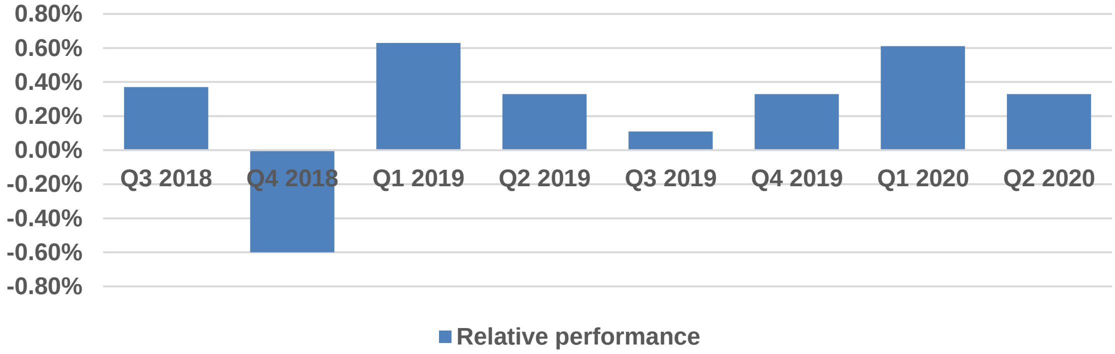
Source: eVestment (based on 171 Global Core Developed portfolios)

3.4 However, this benchmark has a higher exposure to US (67% v. 40%) and a lower exposure to Europe ex-UK (18% v. 30%) and Pacific ex-Japan (4% v. 20%) than the sub-fund's benchmark. Comparing the performance and risk of the sub-fund (relative to its composite benchmark) and the equivalent information for the peer group (relative to the MSCI World ex-UK benchmark) would result in the sub-fund being at the upper end of the first quartile.

Overseas Developed Markets (quartile ranking)	**1 year**	**Since inception**
Relative performance	1st	1st
Information ratio	1st	1st

Source: eVestment (based on 171 Global Core Developed portfolios)

3.5 Performance has been relatively strong and consistent during the last year. It is pleasing to note that the sub-fund was able to out-perform both during the market correction but also during the subsequent recovery. The only period of under-performance since inception occurred in Q4 2018 due to rising bond yields adversely impacting quality and bond proxy stocks; a reduction in earnings expectations; and the escalation of the US/China trade war, which had a disproportionate impact on technology stocks in which the sub-fund was overweight.



3.6 The majority of the out-performance is due to stock selection with sector allocation making a more modest contribution. The key reasons for out-performance during the year were:

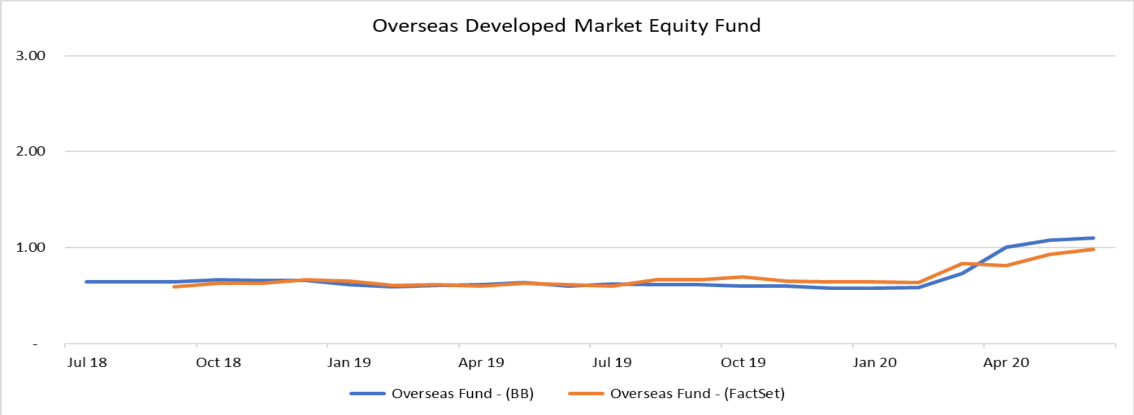
- Stock selection in:
    - Consumer Services (o/w in Dollar General and Amazon);
    - Consumer Goods (o/w in NCSoft); and
    - Technology (o/w in Nvidia, Microsoft and Logitech).
- Sector allocation:
    - u/w Financials (particularly Banks); and
    - o/w Technology.

This was partly offset by weaker stock selection in Industrials (o/w Airbus) and Healthcare, and an overweight position in France.

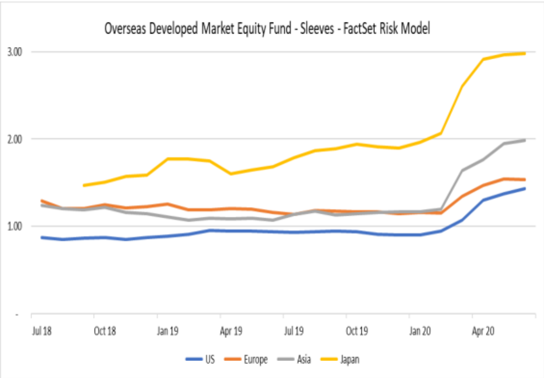
3.7 The sub-fund has a quality and growth bias with a focus on companies that can withstand economic and market volatility. Quality is defined as companies with an identifiable and sustainable competitive advantage, earnings visibility, balance sheet strength and strong management.

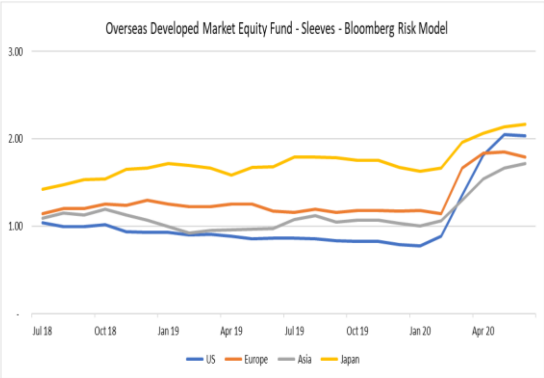
Risk profile

3.8 The tracking error has increased recently to c. **1%** on an ex-post basis (from c. 0.6%) which is at the bottom end of the target range of 1 – 3%. The increase in tracking error has been due to a combination of an increase in market volatility and a reduction in the number of stocks held. The information ratio, a measure of the excess return relative to the risk of the portfolio, since inception has been exceptionally strong at **1.9**.



3.9 The tracking errors of the individual portfolios have increased in recent months due to the increase in market volatility and a reduction in the number of holdings. Tracking errors range from 1.4% (US) to 3% (Japan) using FactSet although there has been a notable divergence between the FactSet and Bloomberg risk models since the market correction (this is due to the relative weightings of near term experience).





3.10 Although the individual portfolios are considered to be taking a suitable level of risk, the risk profile of the sub-fund as a whole is significantly lower. The key reasons for this are the number of stocks in the sub-fund (c. 330) resulting in diversification (although efforts have been made to reduce the number of stocks over the last year) and portfolio positioning in the US appears to have an offsetting effect on the risk at a sub-fund level (lower relative exposure to Basic Materials, Industrials and Technology and relatively higher exposure to Consumer Services). These are not significant differences and some of it is due to how stocks are classified in the different markets.

3.11 The key contributors to risk are:

- Stock-specific risk (c. 52% of total risk, individual portfolios range from 60 – 70% but diluted at sub-fund level).
- Style risk (c. 25%) – overweight to lower volatility stocks and underweight to value stocks are the key style exposures.
- Industry (c. 11%) – underweight to Consumer and Financials are the key risk exposures.
- Country (c. 10%) – overweight to France and underweight to Nordics are the key risk exposures.

Benchmark

3.12 The current benchmark is a composite of the following:

- **S&P 500** (40% – c. 505 stocks) – common benchmark for US stocks and considered to be appropriate but it should be noted that the sub-fund does not have an exposure to Canadian stocks (unless held as off-benchmark positions) which account for c. 10% of North America.
- **FTSE Developed Europe ex-UK** (30% – c. 455 stocks) – common benchmark for European stocks and considered to be appropriate.
- **FTSE Developed Pacific ex-Japan** (20% – c. 380 stocks) – although it is a relatively common benchmark it does include South Korea which is classified as an emerging market by MSCI, another popular index provider. The existing benchmark for the Emerging Markets sub-fund (S&P Emerging) does not include South Korea Border to Coast is in the process of redesigning the current internal Emerging Markets fund into a hybrid fund (consisting of an external China specialist with the ex-China portfolio being managed internally) and the favoured benchmark is FTSE Emerging Markets. As this does not include South Korea, and so there will be no overlap, it is considered appropriate that the current benchmark for Pacific ex-Japan is retained.
- **FTSE Japan** (10% – c. 510 stocks) – common benchmark for Japanese stocks and although the Nikkei is a more recognised benchmark this has a bias towards larger companies (largest 225 companies).

Re-balancing and Liquidity

3.13 There have been 4 rebalancing exercises during the year (two in February 2020 and two in April 2020). In June 2020, a change in the rebalancing methodology was agreed. Portfolios will now be rebalanced on a quarterly basis in line with the resetting of the benchmark weights, and only rebalanced intra-quarter if the variation is due to portfolio alpha rather than benchmark movements.

3.14 In terms of liquidity, the sub-fund is very liquid and there have been no instances where liquidity metrics have been breached.

Resources

3.15 The sub-fund is managed by four Portfolio Managers (Shaun Lovett – US, Amit Taank – Europe, Myles Andrews – Asia Pacific, and David Vincent – Japan). The only change since last year's review is that David Vincent has been promoted to Portfolio Manager and has assumed sole responsibility for the Japanese portfolio. This was in recognition that each portfolio required a dedicated Portfolio Manager as a minimum.

3.16 The Portfolio Managers are supported by the wider Research team.

3.17 At the last annual review, it was considered that four Portfolio Managers supported by three Research personnel and the wider resources in the Investment function should be sufficient to manage the portfolios. This remains the case but will continue to be reviewed on a regular basis to ensure that this remains valid. In addition, James McLellan will joined Border to Coast in September as Senior Portfolio Manager – Equities and will provide additional support and oversight. Long term succession planning is included within the Strategic Plan 2020 – 22.

Portfolio structure

3.18 The original design for the Overseas Developed Markets sub-fund included an element of flexibility in the event that investors wanted to separate the four portfolios into separate sub-funds at a later date. As a result, each portfolio is managed separately.

3.19 As part of last year's annual review, two potential changes to the portfolio structure were considered and discussed with existing investors:

- Dispense with the separate portfolios for each region and manage the sub-fund on a Global basis with each Portfolio Manager continuing to monitor their region but with collective decision making;
- Continue to manage the sub-fund as four separate portfolios but with greater levels of concentration within each portfolio and a consideration of relative value between regions when constructing the portfolios.

3.20 These potential changes were considered appropriate in terms of a more efficient use of resources and increasing the level of portfolio risk commensurate with the target tracking error.

3.21 It was decided that it was too early in the life of the sub-fund to consider material changes as to how it is operated. It was agreed that Border to Coast undertake further work as to how this would operate in practice and revisit at a later date. Border to Coast will undertake further work on potential options and will share these with investors.

Portfolio construction

3.22 The number of holdings has reduced from c. 410 (as at 30 June 2019) to c. 330 (as at 30 June 2020) as a result of portfolio rationalisation (average: c. 360). This process is expected to continue, albeit to a lesser extent, in the short term. This is to ensure the portfolios are targeting a level of risk which is commensurate with the return target.

3.23 The active share is **41%** which would not typically be categorised as "active management" although the strong risk-adjusted performance is not consistent with this categorisation. The active share in the US and European portfolios are in line with the sub-fund, Japan is higher (c. 60%) and Pacific ex-Japan is lower (c. 33%).

3.24 Portfolio turnover has averaged **c. 11%** during the year which is at the level expected prior to launch and is compatible with a long term focus on fundamental analysis.

ESG and Responsible Investment

3.25 ESG and Responsible Investment is considered an integral part of the investment process with a dedicated ESG section in the investment documentation for each company. The Portfolio Managers have developed a greater understanding of ESG and RI through interaction with the RI team and external service providers.

3.26 ESG screens and carbon footprints are analysed on a quarterly basis which highlights any material ESG and carbon risks in the portfolio. Portfolio Managers also participate into the voting process with key resolutions discussed with the RI team. Work is ongoing to further embed this into the investment process including regular training sessions and an increase in engagement with portfolio companies where appropriate, although it is acknowledged that this may be harder to achieve in overseas markets.

Customer requirements

3.27 Feedback has been sought from the Partner Funds that are currently invested in the sub-fund. In addition to the issues that were raised as part of the UK equity sub-fund review, the following key questions (and responses) were:

- *Will you be providing updates on ESG?* We are currently developing additional ESG and RI reporting to share with Partner Funds.
- *How has the process developed since inception and has it changed the level of conviction?* The core investment philosophy has remained broadly unchanged since inception. The increased resources, particularly within the Research function, has enabled more detailed due diligence. This has aided the Portfolio Managers in reducing the number of stocks held, particularly within the Overseas Developed sub-fund. This process is expected to continue, and it is likely that portfolio conviction will increase further over time.
- *Has the recent dislocation challenged the investment thesis for the funds or reinforced the approach?* The sub-funds' focus on quality companies with strong balance sheets, an identifiable competitive advantage, and income visibility has resulted in relative out-performance in 2020. There has been some modest rotation out of these out-performing stocks into more cyclical stocks in anticipation of a potential recovery. However, there is unlikely to be a material change in the types of companies that are targeted by the sub-fund.
- *Are you using enough of the sub-fund's risk budget and how is portfolio risk expected to develop over time?* The risk profiles of the individual portfolios are in the middle of the indicative range due to an increase in market volatility and a reduction in the number of holdings. Correlations between portfolios has had a dampening effect on the risk profile of the sub-fund as a whole, which has been toward the lower end of the range since inception. This has not had a detrimental impact on performance since inception. Higher conviction positions and a lower number of stocks is likely to result in an increase in risk profile over the long term. However, the portfolios will continue to be managed on a low risk basis.

4 Conclusion

4.1 The annual sub-fund review of the Overseas Developed Markets equity sub-fund has been completed. Performance, in both absolute and risk-adjusted terms, has been strong, particularly in the last year.

4.2 No significant issues have been raised during the review although the following areas have been highlighted:

- Ensuring suitable resources are available to manage the sub-fund, particularly for succession planning.
- Increasing the active risk in the sub-fund, via a reduction in number of holdings and increasing relative over and underweight positions where considered to be appropriate. However, the low risk profile has not had a detrimental impact on absolute or risk-adjusted performance.
- Ensuring continued progress in embedding ESG factors and Responsible Investment more generally into the investment process.
- The benchmark for Pacific ex-Japan is considered appropriate given the proposed benchmark for Emerging Markets Hybrid (avoiding overlap with South Korea).

- Further investigating more efficient and effective ways of managing the sub-fund in the long term.

5 Author

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