



## NOTICE OF MEETING

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# Special Pensions Committee

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THURSDAY, 30TH APRIL, 2009 at 19:00 HRS - CIVIC CENTRE, HIGH ROAD, WOOD GREEN, N22 8LE.

MEMBERS: Councillors Rahman Khan (Chair), Adje, Beacham, Basu, Butcher, Thompson and Wilson

IN ATTENDANCE: Howard Jones, Roger Melling, David Fishman and Earl Ramharacksingh

### AGENDA

1. **APOLOGIES FOR ABSENCE**
2. **URGENT BUSINESS**

The Chair will consider the admission of any late items of urgent business. This being a special meeting of the Committee, under Part Four, Section B, Paragraph 17 of the Council's Constitution, no other business shall be considered at the meeting.

### **3. DECLARATIONS OF INTEREST**

A member with a personal interest in a matter who attends a meeting of the authority at which the matter is considered must disclose to that meeting the existence and nature of that interest at the commencement of that consideration, or when the interest becomes apparent.

A member with a personal interest in a matter also has a prejudicial interest in that matter if the interest is one which a member of the public with knowledge of the relevant facts would reasonably regard as so significant that it is likely to prejudice the member's judgement of the public interest and if this interest affects their financial position or the financial position of a person or body as described in paragraph 8 of the Code of Conduct and/or if it relates to the determining of any approval, consent, license, permission or registration in relation to them or any person or body described in paragraph 8 of the Code of Conduct.

### **4. ASSET ALLOCATION REVIEW (PAGES 1 - 28)**

Report of the Chief Financial Officer to provide an update on the review of the decision making for consideration by Trustees.

### **5. EXCLUSION OF PRESS AND PUBLIC**

The following item is likely to be the subject of a motion to exclude the press and public from the meeting as it contains "exempt" information as defined in Section 100A of the Local Government Act 1972, namely that they contain information relating to the business or financial affairs of any particular person (including the Authority holding that information".

### **6. REVIEWING THE POSITION OF A FUND MANAGER (PAGES 29 - 68)**

Report of the Chief Finance Officer to review the position of a Fund Manager.

**It being a special meeting of the Committee, under the Council's Constitution, Part 4, Section B, Paragraph 17, no other business shall be considered.**

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Wednesday, 22 April 2009



**Haringey** Council

Agenda item:

**Pensions Committee**

**On 30/04/09**

Report Title. **Asset Allocation Review**

Report of **The Chief Financial Officer**

Signed :

Contact Officer : **John Hardy – Corporate Finance**  
**Telephone 020 8489 3726**

Wards(s) affected: **All**

Report for: Non key decision

**1. Purpose of the report**

- 1.1. To provide an update on the review of the decision making on asset allocation for consideration by Trustees.

**2. Introduction by Cabinet Member**

- 2.1 Not applicable.

**3. State link(s) with Council Plan Priorities and actions and /or other Strategies:**

- 3.1. This report links in with the need to regularly monitor the performance of the Pension Fund.

#### **4. Recommendations**

- 4.1 That Members introduce an active asset allocation rebalancing strategy on a quarterly basis as set out in this report.
- 4.2 That Hewitt provide the asset allocation review service and that the budget be amended to reflect this.
- 4.3 That if any asset allocation changes made need revising in between quarterly meetings of Pensions Committee that decisions are delegated to the Chief Financial Officer in consultation with the Chair of the Pensions Committee.
- 4.4 That members note the outcome of the procurement process for a passive Fund manager.

#### **5. Reason for recommendations**

- 5.1. The Council's external investment advisors, Hewitt, have suggested that an active asset allocation rebalancing strategy is an appropriate process to have in place. As markets can be volatile in the short and medium term this is a concern. This proposal can present opportunities to reduce risk and improve returns in line with the approved investment strategy.

#### **6. Other options considered**

- 6.1. This provides Members with an additional service to that currently employed in the management of the Pension Fund. Options for provider and funding are explored.

#### **7. Summary**

- 7.1. Further to the last report considered at Pensions Committee on 29 January 2009 this report considers a proposal for an active asset allocation rebalancing strategy and sets out the estimated costs and benefits.
- 7.2. It is considered appropriate to review the balance of the Fund's asset allocation on a quarterly basis in between three yearly full reviews of investment strategy. It is suggested that decisions on asset allocation should be made as part of reports presented to the Committee each quarter with active rebalancing advice received from Hewitt. This will ensure that Pensions Committee directly controls any changes to investment strategy on a quarterly basis.

#### **8. Head of Legal Services Comments**

- 8.1. The Head of Legal Services has been consulted on the content of this report and comments that the Committee should give full consideration to the financial

advice received concerning the introduction of an active asset allocation rebalancing strategy. Such a strategy should only be approved if the Committee considers that it will assist it in meeting its duties concerning the overview of investment activity and performance of the Pension Fund in order to ensure the suitability of investments and types of investments.

## **9. Equalities & Community Cohesion Comments**

9.1. There are no equalities issues arising from this report.

## **10. Consultation**

10.1. Not applicable.

## **11. Chief Financial Officer Comments**

11.1. The introduction of active asset allocation rebalancing to the fund is likely to add value although the potential risks and benefits will need to be considered on a constant basis. Decisions and the impact will be reviewed each quarter. It is suggested that if any asset allocation changes made need amending in between quarterly meetings of Pensions Committee that decisions are delegated to the Chief Financial Officer in consultation with the Chair.

11.2. Hewitt have confirmed that as part of the active allocation service the Council would receive each quarter the standard four page report as appended to this report and receive their conclusions and recommendations tailored to Haringey and report on the impact of previous asset allocation decisions made.

11.3. Fees payable to the passive manager would be charged to the Pension Fund, and be offset against the fees that would have been paid to an Active Fund Manager. The fees paid to an Index Tracker Fund Manager are considerably less than those made to an Active Fund Manager.

11.4. Hewitt advise that the annual cost for receiving their active asset re-balancing proposals each quarter as produced by their Asset Allocation team is £30k. This cost includes presenting these proposals at meetings of Pensions Committee. This is not included in the current budget or the current contract with Hewitt, and therefore this variation would need to be implemented.

11.5. Costs will be funded from the Pension Fund. The cost of the service should be more than offset by additional performance returns made by the Fund by following an active asset re-balancing strategy. The Council could seek quotes from other providers, however this would mean having different advisors for different parts of the strategy and it is not recommended this is the most consistent approach.

**12. Use of appendices /Tables and photographs**

12.1. Appendix 1 - report by Hewitt.

**13. Local Government (Access to Information) Act 1985**

13.1 Updates on Asset Allocation reports and presentations by Hewitt to Pensions Committee on 18 September 2008 and 29 January 2009.

**Background**

- 14.1 Pensions Committee on 29 January 2009 considered a report on the possible introduction of an active quarterly rebalancing strategy and agreed that a further report be brought to Pensions Committee giving detailed proposals for an asset allocation rebalancing strategy including costs.
- 14.2 A report is appended from the Council's investment advisors. This report covers the aims of strategic asset allocation and medium term asset allocation, reviews actual changes in the Fund's asset allocation during 2008, details potential changes in the Fund's asset allocation during 2008 if Hewitt's medium term asset allocation advice had been received and followed, outlines risks attached to medium term asset allocation, details conclusions that can be drawn from the analysis, shows the most recent advice from Hewitt re asset allocation, and how the Committee might consider asset allocation moves going forward on a quarterly basis.
- 14.3 Should the Committee agree to introduce an active rebalancing strategy a preferred mechanism for making changes between asset classes would be to access pooled funds through the Fund's new passive manager. Trustees will recall that Pensions Committee on 20 October 2008 delegated authority to the Chief Financial Officer to appoint an Index Tracker Fund Manager to a framework agreement for a four year contract period.
- 14.4 A procurement process was undertaken with the active support of Hewitt. This is a Part A Financial Service under the OJEU regulations. Hewitt managed the EU procurement process on the Council's behalf. This was done under the oversight of the Council's Corporate Procurement Unit and Legal Services who were fully consulted on this matter. The Council were fully involved in the process at each stage to agree the steps taken by Hewitt before they were actually completed and to ensure full compliance with EU regulations.
- 14.5 Three managers were approached and Legal and General was selected from among them having submitted the most beneficial bid. The Head of Legal Services has

almost completed the required legal work with Legal and General and therefore an agreement will be signed shortly.

### **Aim of asset allocation**

- 14.6 The aim is to increase the funding level of the Pension Fund and to reduce risk of losses. The Investment Strategy is set for the long term. Considering asset allocation in the short and medium term is important in order to make adjustments to any prevailing economic conditions.

### **Aims of Medium Term Asset Allocation**

- 14.7 There are times when particular asset classes look more attractive than others. Therefore it is sensible to consider moving between mis-priced asset classes; from over-priced to under-priced asset classes.

### **The Fund's asset allocation in 2008**

- 14.8 2008 was a very volatile year for the markets. As shown in the Appendix the Fund's allocation in equities started the year above the benchmark in the approved investment strategy and ended the year below benchmark. The allocation in bonds started the year above benchmark and ended the year above benchmark. This occurred as the market changed and not by any proactive decision by the Council.

### **Modelling exercise and results**

- 14.9 The appended report shows Hewitt's quarterly investment outlook updates that are produced by their Asset Allocation team for October 2008 and January 2009. The appendix also shows the estimated impact on performance if Hewitt's Medium Term Asset Allocation advice (active asset allocation rebalancing) had been received and followed during 2008, although this was very volatile period in the market. Hewitt have modelled and concluded that their recommended changes would have led to an additional 3.2 per cent on the Fund's total performance that is assumed to reduce to 3 per cent after transaction costs.

### **Risk**

- 14.10 The largest risk of Medium Term Asset Allocation is that the changes made are unsuccessful or would have the opposite effect. This would decrease investment returns and increase the risk of the strategy to the fund. However, by monitoring this on a quarterly basis then this could be corrected swiftly.
- 14.11 Hewitt's report shows the impact of a Medium Term Asset Allocation on risk is considered. This shows that the probability of portfolio losses based on the statistical analysis of historical price trends and volatiles can be estimated using a technique called Value at Risk.

14.12 The analysis shows that, despite moving assets away from the long term strategic benchmark, the actual risk of the strategy, as measured by the Value at Risk technique, has in each instance reduced for the modelling based on 2008.

14.13 There is also the risk is that the investment strategy does not close the funding gap. If the Fund is not rebalanced regularly then over time the strategy changes as the asset allocation varies from the benchmark and the associated risk taken changes.

#### **How Medium Term Asset Allocation advice would work in practice**

14.14 Each quarter Hewitt would prepare a report setting out the views of their Asset Allocation team. Hewitt would present this report to Pensions Committee and recommend any changes to the Fund's asset allocation. There would also be a covering report from the Chief Financial Officer that gives advice. If agreed, implementation would be delegated to officers. Officers would instruct Legal and General, the Fund's new Passive Manager, to buy/sell equity/bond pooled fund units.

14.15 If it is agreed to introduce active allocation the actual performance of any changes would be monitored. This would be included in the quarterly covering report at the same time of the next review.

#### **Possible funding**

14.16 Some assets could be transferred from an existing Fund Manager to fund the passive manager.

14.17 This will have the benefit of not incurring additional trading costs as the passive manager is likely to be able to absorb existing equities and bonds directly into the pooled funds, in exchange for units.

14.18 Another source of funding could be from the annual net gain as current employers and employee contributions exceed pension payments. Whilst this is currently earmarked for property and private equity calls it is considered that such investments will take longer to make in the current economic climate.

#### **Conclusions**

14.19 The Fund has a long term investment strategy in place with full reviews of strategy undertaken every three years.

14.20 The Fund does not currently rebalance to benchmark in between these full reviews of investment strategy. Markets can be volatile in the short and medium term. This proposal represents an opportunity to reduce risk and improve returns for the fund.

14.21 It is considered appropriate to review the balance of the Fund's asset allocation on a quarterly basis in between full reviews of investment strategy. It is suggested that decisions on asset allocation should be made as part of reports presented to the



Committee each quarter with active rebalancing advice received from Hewitt. This will ensure that Pensions Committee directly controls any changes to investment strategy on a quarterly basis.

- 14.22 A preferred mechanism for making changes between asset classes would be to access pooled funds through the Fund's new passive manager.

# Asset Allocation Decisions London Borough of Haringey Pension Fund



20 April 2009

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Prepared for  
London Borough of Haringey Pensions Committee

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## Introduction

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### Introduction

The Pensions Committee has discussed asset allocation as a topic on two previous occasions:

1. At the meeting of 18<sup>th</sup> September 2008, discussion took place regarding the topic of the Fund's investment strategy;
2. At the meeting of 29<sup>th</sup> January 2009, a formal report on asset allocation was submitted by Hewitt which went in to the topic in more detail, covering:
  - the purpose of asset allocation;
  - the movement of the Fund's asset allocation 2008;
  - whether asset allocation decisions should be taken more frequently than they currently are;
  - the risks to the Fund of such a course of action; and
  - what sort of framework and mechanism could be put in place to make more timely asset allocation decisions

Hewitt also gave a short presentation prior to the discussion of the report, to set the scene. During the subsequent discussions, it became clear that the Committee, whilst accepting that a more active approach to asset allocation might be beneficial to the Fund, wished to see some Fund specific performance numbers modelled to try to demonstrate the potential benefit of having a more active approach to asset allocation.

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### Purpose of this report

This report aims to address the Committee's request for the additional work to be done prior to any decision being made as to whether a more fluid asset allocation approach should be taken.

This new report aims to cover the following areas:

- A short refresher on what we mean by asset allocation;
  - A review of the actual moves in the Fund's asset allocation during 2008;
  - The results of the additional work Hewitt has undertaken on behalf of the Fund to try to quantify potential moves in the Fund's asset allocation during 2008 that would have come about if our medium term asset allocation advice had been followed;
  - Some potential risks attached to medium term asset allocation moves;
  - Any conclusions that can be drawn from the analysis;
  - The most recent advice that has come from our AA team; and
  - How the Committee might consider asset allocation moves going forward on a quarterly basis.
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## Refresher on Asset Allocation

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### **The Aim of Strategic Asset Allocation**

How to invest the Fund's assets is the most important decision that the Pensions Committee will make. Whilst the overall Funding Policy is set with the Fund's investment strategy in mind, it is the success – or otherwise – of the asset allocation decisions that will drive the overall investment returns.

Generally speaking, almost all LGPS Funds have a funding deficit of some sort – some relatively small, some much larger. Given the enduring nature of local government, and the relative immaturity of LGPS Funds, it is generally accepted that there is little need to have assets invested in lower yielding investments that more closely match liabilities.

The hope over time is that by running a deliberate mismatch policy and investing predominantly in equities, deficits will be reduced, or even closed – allowing investment strategies to become more liability focussed in the future, and meaning that the Employers, Scheduled and Admitted Bodies in the Fund do not have to close the funding gap purely by paying in additional cash amounts (something which precious few can afford).

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### **The Aims of Medium Term Asset Allocation**

When setting the investment strategy, the Committee will consider the long term expected returns of asset classes. As the Committee knows all too well, both good years and bad years make up the long term.

There are points in time where particular asset classes look more attractive than others, and we would argue that it is sensible to consider moving cash between mispriced asset classes – i.e. from overpriced to underpriced asset classes.

When the Fund sets its investment strategy, it is plotting a course for the long term. Medium term asset allocation can be considered to be 'trimming the tiller'. It is not just about seeking better returns – it is equally valuable in trying to avoid losses.

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## Fund Asset Allocation Movements in 2008

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### Unplanned asset movements during 2008

As is the case with most LGPS Funds, the Haringey Pension Fund invests predominantly in equities. Whilst there is no readily accessible information source that show the estimated funding level of all LGPS funds, we can compare the Fund's asset allocation policy to the WM Local Authority Index, which is an index comprised of the asset allocations and investment returns of the majority of local authority pension funds in the UK.

The approximate asset allocation of the Fund as shown in the Northern Trust custody reports as at the end of each quarter was as follows:

Asset Class	Benchmark %	Fund at 31/03/08 %	Fund at 30/06/08 %	Fund at 30/09/08 %	Fund at 31/12/08 %
Equities	65.0	67.8 (65.1)	67.4 (64.5)	64.7 (62.3)	63.5
Bonds	20.0	21.8 (18.1)	22.4 (18.1)	24.3 (19.7)	26.0
Property	10.0	8.6 (7.4)	8.3 (7.2)	7.9 (7.5)	7.9
Private Equity	5.0	0.5 (*5.0)	0.6 (*5.4)	1.2 (*5.9)	2.3
Cash	-	1.3 (4.4)	1.3 (4.8)	1.9 (4.6)	0.3
Total Fund	100.0	100.0	100.0	100.0	100.0

*(WM Local Authority index weights shown in brackets in italics above)*

*\* - includes allocations to Hedge Funds and other alternatives*

The main thing that the table shows is that the Fund was overweight equities at the start of the year. This overweight position reduced as the year progressed and equities continued to perform poorly.

It would have been beneficial for the Fund's overall investment return if it had, at the least, reduced the equity exposure to be in line with the benchmark at the start of the year. We would go further than that by restating our view that making asset allocation moves based on expert advice has the potential to enhance the Fund's returns further than simply using a passive rebalancing model.

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## Modelling Exercise & Results

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### Modelling Exercise

At the last Committee meeting, the Committee expressed a wish to see some further analysis on what asset allocation moves might have been made, using Hewitt's medium term asset allocation advice.

We have collected asset value information from the Fund's custodian, Northern Trust, for the Fund's asset values as at 31 December 2007, 31 March 2008, 30 June 2008, 30 September 2008 and 31 December 2008. This information has formed the basis of our analysis.

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### Assumptions Used

When carrying out the analysis, we made a number of assumptions:

- 1) That the main focus of the Committee would be on the relative weights allocated to equities and bonds. To that end, we have essentially ignored the property and private equity assets
  - 2) Any modelled move between equities and bonds would not be allocated to a specific asset manager – i.e. we have used the managers in a random manner in this exercise, ignoring any preference dictated by our own manager rating system
  - 3) That any assets notionally transferred to an investment manager earned the returns generated by that manager
  - 4) That there were no objections to the Fund being up to 35% invested in bonds, and having as little as 59% in equities. In real life the Fund would have bands in place for each of the major asset classes – for example, to have an equity exposure of 65% with a tolerance of +/- 10%
  - 5) That rebalancing would have occurred once per quarter
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### Our suggested asset moves during 2008

Our Asset Allocation team produce quarterly outlook notes which state their views on the attractiveness – or otherwise – of all of the major asset classes. The note issued in October 2008, and the most recent note issued in January 2009, are included as Appendices to this report. However, we state below what our views would have been for each quarter of 2008:

- Note produced Jan 08 - reduce equities to benchmark / underweight; increase corporate bonds to benchmark / overweight if possible
  - Note produced Apr 08 - reduce equities to benchmark / underweight; increased corporate bonds to benchmark / overweight if possible
  - Note produced Jul 08 – remain benchmark / underweight in equities; increase corporate bonds to benchmark / overweight if possible
  - Note produced Oct 08 – remain benchmark / slightly underweight in equities ; increase Index Linked Gilts to benchmark / overweight if possible, increase corporate bonds to benchmark / overweight if possible
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### Results

Using the recommendations from the asset allocation team's notes, we have modelled the possible flows of assets within the Fund's actual asset allocation over the year, as shown in the following table:

<b>Asset Class</b>	<b>Benchmark Weight (%)</b>	<b>Modelled (Actual) % Fund at 31/12/07</b>	<b>Modelled (Actual) % Fund at 31/03/08</b>	<b>Modelled (Actual) % Fund at 30/06/08</b>	<b>Modelled (Actual) % Fund at 30/09/08</b>	<b>Modelled (Actual) % Fund at 31/12/08</b>
Equities	65	59 (69)	58 (67)	60 (67)	60 (66)	59 (64)
Bonds	20	32 (22)	33 (22)	31 (22)	31 (24)	31 (26)

### Modelling Output

We show below the data that came out of the modelling in numerical form, in terms of estimated quarterly performance compared against actual quarterly performance as calculated by Northern Trust.

We have also stated how the cash was moved between managers in the modelling exercise:

#### As at 31 March 2008

The quarterly estimated performance was -6.4%, compared to the actual performance of -7.4%.

The model had assumed that 11% had been sold from equities (6% taken from Alliance Bernstein UK Equities and 5% from Capital International Global Equities), and had been reinvested in the Fidelity Fixed Income mandate at the end of 2007.

#### As at 30 June 2008

The quarterly estimated performance was -3.5%, compared to the actual performance of -3.9%.

There were no changes in asset allocation assumed by the model at the start of this quarter.

#### As at 30 September 2008

The quarterly estimated performance was -6.7%, compared to the actual performance of -7.7%.

We slightly reduced the underweight position in equities by selling 3% from the Fidelity Fixed Income mandate and allocating 1% to Capital International Global Equities and 2% to Fidelity Global Equities, at the start of the quarter.

#### As at 31 December 2008

The quarterly estimated performance was -2.8%, compared to the actual performance of -3.5%.

We further reduced the underweight position in equities by taking 6% from the Fidelity Fixed income mandate and allocating 2% to Alliance Bernstein UK Equities, 2% to Capital International Global Equities and 2% to Fidelity Global Equities, at the start of the quarter.

### Overall outcome

The main events that drove performance during the period covered by the modelling were the significant falls in the value of global equities in quarters 1, 2 and 3. The modelling exercised had reduced the Fund's exposure to equities prior to these periods, although some money was fed back into equities (as they continued to underperform during the year, the positions were increased so as to be in touch with, but still underweight of, the benchmark).



Overall, this represents an additional +3.3% on the Fund's total performance.

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## **Possible Transaction Costs**

We have undertaken a relatively simple and straightforward modelling exercise for the Committee. It should be noted that it is very difficult to calculate exactly how things would have turned out.

One of the things we have not modelled is the impact of transaction costs on the asset moves. Whenever the Fund's manager buys or sells equities or bonds, they incur costs.

For equities, the costs are explicit, and we would identify them as:

- the difference between the bid (valuation) and mid (actual selling) price;
- brokers' commissions
- any local taxes

For bonds, the costs tend to be included in the price for the actual bond, and so are less easy to identify.

For arguments sake, and using our knowledge of overall transaction costs, we have assumed that the transaction costs for this exercise would have been in the region of 0.15-0.20%.

Therefore, we should reduce the overall performance number by this amount, which brings us to a figure of approximately +3.1 for the year

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## **A note on selling assets**

Although this is simply a modelling exercise, it is worthwhile considering what would have happened to the assets regarding instructing the investment managers. For example:

The model had assumed that 11% had been sold from equities (6% taken from Alliance Bernstein UK Equities and 5% from Capital International Global Equities), and had been reinvested in the Fidelity Fixed Income mandate at the end of December 2007.

Therefore:

- the equity managers would have had to realise a slice of assets from their portfolios;
- the cash would have had to have been transferred to Fidelity;
- who would then have had to go out a buy some bonds

All this seems slightly cumbersome – however, we should at this point remind the Committee that it has decided to appoint Legal and General as a passive investment manager. Asset allocation moves made through this manager would be much more straightforward, with LGIM instructed to sell units in any equity holdings and buy units in appropriate fixed interest pooled funds.

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## Associated Risk

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### What this means in terms of 'risk'

Risk can mean many things when mentioned with regard to a fund's investment strategy. In our opinion, the biggest risk that the Committee faces by employing a medium term approach to asset allocation moves is that the moves are unsuccessful, and that as a result the overall investment return is decreased, and that the risk of the strategy to the Fund is increased.

### Impact of MTAA on Risk

When we look at the Fund's overall investment strategy we look at a number of measures of risk, which can include the possible impact on contribution rates and accrued funding ratios. We also produce statistics such as Value at Risk which is used in a number of financial organisations to measure the probability of certain extreme defined outcomes.

What does Value at Risk mean?

Value at Risk (or VaR) is a technique used to estimate the probability of portfolio losses based on the statistical analysis of historical price trends and volatilities. Therefore, VaR is a useful tool for evaluating financial risk.

We express VaR as a cash amount, expressed in millions, that represents the minimum likely loss under a 1 in 20 event

As part of this modelling exercise, we have calculated the VaR numbers at the end of each quarter for both the actual investment allocation and the modelled allocation. They are shown below:

	Total VaR	Total Var in rebalanced portfolio	Difference	% reduction in VaR
Q4 07	154.83	141.81	13.03	8%
Q1 08	178.34	160.09	18.26	10%
Q2 08	177.03	164.18	12.85	7%
Q3 08	173.78	163.71	10.07	6%

This analysis shows that, despite moving assets away from the long term strategic benchmark, the actual risk of the strategy – as measured by VaR – has in each instance been reduced. Some specific points worth noting relating to the calculations are:

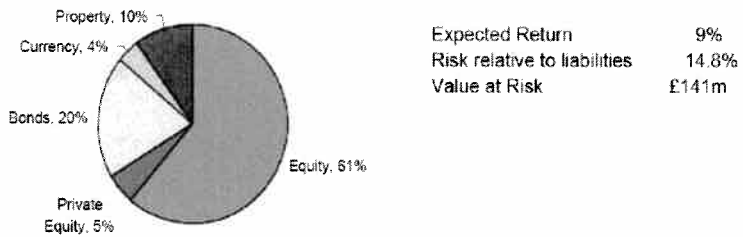
- Our asset allocation team update their 10 year Global assumptions each quarter, each of the above has been calculated using the assumptions prevalent at that date.
- Since this is a retrospective exercise, the return/risk for each asset class is known. The figures in the table represent our best estimates of the portfolio's risk as at the end of each quarter.
- Our AA team base their recommendations for asset classes based on medium term asset allocation views, that is, they may see an asset class trading at prices that are attractive or unattractive relative to their long term assumptions. Consequently, the risk/return profile of asset classes used in calculating VaR will be out of sync with the assumptions used in the rebalancing decisions.
- As the rebalanced portfolio outperformed the fixed portfolio, the VaR of the rebalanced portfolio would have naturally increased in line with the relative increase in assets. We have compensated for this by assuming that each portfolio had the same asset values for each quarter. This gives a more appropriate indication of how much risk was being taken each quarter by the portfolios.

**Impact of MTAA on Return Objectives**

The aim of making asset allocation moves is to increase exposure to assets that are expected to perform well, and to reduce exposure to assets that are expected to underperform.

We have previously analysed the Fund's investment strategy in terms of risk and return. When we reviewed it back in June 2008, it looked like this:

**Current Investment Strategy**



Expected Return 9%  
 Risk relative to liabilities 14.8%  
 Value at Risk £141m

- The assumed return in the actuarial valuation was 7.3%pa. Achieving this return would allow full funding in 20 years.
- The current portfolio is expected to return c.9%. The additional return should allow the recovery to full funding within half the time.

Back then, the Fund was already targeting a higher return than the assumed return used by the actuary.

We show in the table below the results of the modelling, in terms of expected return:

Asset Class	Benchmark (%)	Modelled (Actual) %	Modelled (Actual) %	Modelled (Actual) %	Modelled (Actual) %
		Fund at 31/12/07	Fund at 31/03/08	Fund at 30/06/08	Fund at 30/09/08
Equities	65	59 (69)	58 (67)	60 (67)	60 (66)
Bonds	20	32 (22)	33 (22)	31 (22)	31 (24)
Expected return	9.0%	8.1 (8.8)	8.4 (9.2)	8.8 (9.3)	8.6 (9.0)

**What this shows**

It would be slightly simplistic to take the figures at face value – since the assumptions used in the modelling work are Hewitt's long term expected return and volatility figures for each asset class. Any asset allocation move recommended by the AA team is done because they expect to gain a different return – either better or worse – for a specific asset class than its long term expected return.

However, the output from the modelling exercise shown above would seem to indicate that, even when the Fund had its lowest weight in equities at 31/03/08, the long term return expectations for that portfolio of 8.4% were still in excess of the expected return of 7.3% assumed by the Actuary.

## Implementation

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### **How would MTAA advice work in practice?**

An important point to answer is how we would expect the process of asset allocation to work. If the Committee now agrees that medium term asset allocation has the potential to add value to the Fund, we believe the process of how it actually works should look something like this:

- 1) Every quarter, a report detailing the views of Hewitt's asset allocation team is sent to the Fund
  - 2) Hewitt consultants discuss the report at the relevant Committee meeting, and make a recommendation as to how the Fund's asset allocation should be configured in the medium term
  - 3) The Committee also has access to information provided by investment managers and the independent investment advisor on asset allocation options
  - 4) Following discussion, the Committee either agrees or disagrees with the Hewitt recommendation. If agreed, implementation is delegated to the Officers
  - 5) The Officers instruct Legal and General to buy/sell an appropriate amount of equity/bond pooled fund units
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## Conclusions

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### Conclusions

We hope that this report has, at least, illustrated to the Committee the potential effect that employing an active asset allocation rebalancing process can have on the overall Fund asset values and performance.

We further hope that this analysis has answered the question posed at the last meeting regarding attributing some numbers to possible asset allocation moves, and what they might mean for the Haringey Pension Fund.

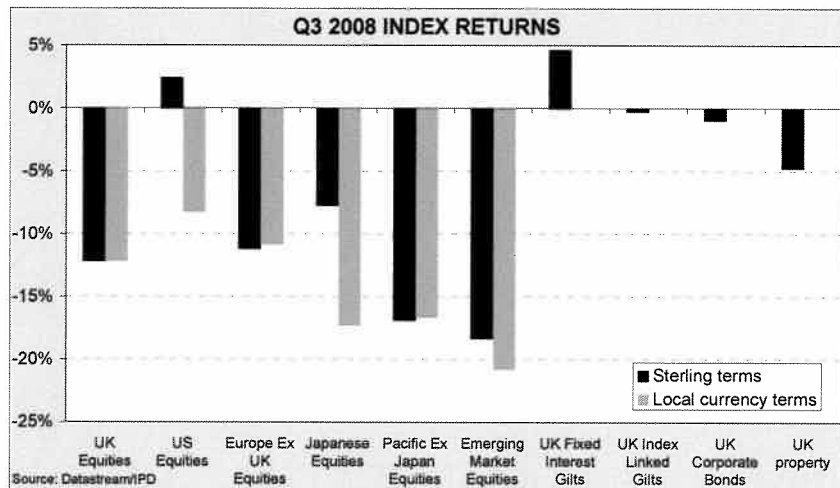
We look forward to discussing this report with the Committee in more detail at the meeting on 30 April 2009.

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## Appendix 1 – Quarterly Investment Outlook October 2008

### Summary

- The focus has moved from US financial turmoil to financial turmoil elsewhere and increasingly to the ever more challenging economic outlook.
- Falling expectations for economic growth have produced a timely decline in commodity prices and inflation is likely to undershoot central bank targets. This has helped index-linked gilt yields rise to our buying threshold.
- Corporate bonds are attractive although the divergence in spreads between financials and other sectors suggests even better buying opportunities may be available.
- Equity valuations have moved into long term attractive territory but we remain concerned about the impact of a very poor news flow.
- Notwithstanding the poor publicity, hedge funds remain an attractive asset class for return seeking funds.



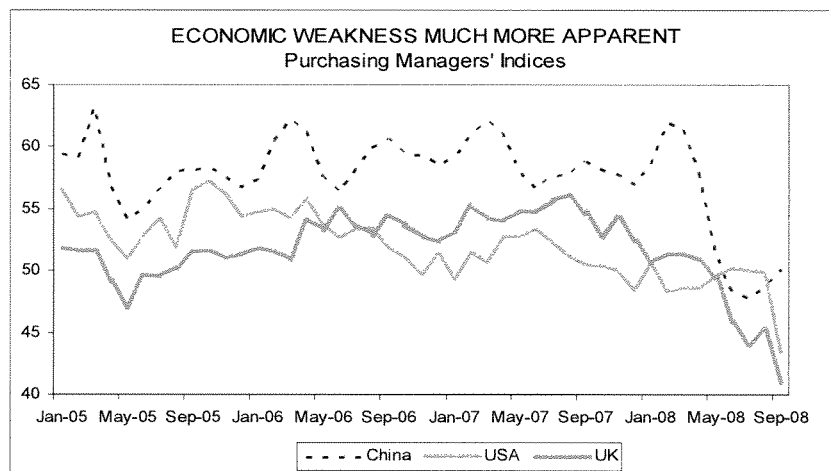
### Excesses exposed

Q3 2008 was when it all went wrong. Banks stopped lending to each other as they questioned the value of their counterparts' assets. The authorities dithered, letting Lehman fail before deciding to spend hundreds of billions of dollars worldwide saving the rest of the banking system. Optimism over the commodity super-cycle and the immunity of emerging markets from developments elsewhere disappeared. Investors rushed into anything they perceived to be a safe haven. And, of course, the situation has deteriorated greatly since the end of the quarter.

Our framework has been that the crisis would unfold in three stages: US financial turmoil, catch-up financial turmoil elsewhere and a realisation of the economic repercussions. The first of these seems to be largely priced into financial markets, although no doubt there will be more bad news to come. The second stage is hitting the headlines as we write: Korea has announced a \$130 billion rescue package, a country (Iceland) has in effect gone bust, a queue is forming for IMF financial support, and rescue packages for European financial institutions are being implemented.

**Economies weaken - everywhere**

The news on the global economy is dismal. Weaker availability of credit is having an impact, while a critical factor has been a large fall in business and consumer confidence. Here in the UK, weakness in housing and stock markets has worsened consumer sentiment, already fragile from the squeeze on real income growth that has resulted from higher inflation. Uncertainty over demand and the availability of financing have deteriorated and businesses are now cutting employment. Difficult as the economic environment is in the UK, it is very much a global problem. Emerging and developed economies alike are showing weakness, as highlighted in many countries by surveys such as purchasing managers' indices. These indicators of the health of manufacturing have now slipped below 50 in a number of countries, suggesting outright falls in manufacturing output (see chart).



**Inflation to fall**

One silver lining from the spill-over of the financial crisis to economic activity is a sharp weakening in commodity prices. For some time, we have argued that the substantial excess of commodity prices over their underlying marginal cost of production made prices vulnerable to a change in demand-supply conditions. As demand weakness for crude oil and other commodities has become more evident, prices have fallen sharply, the speed of the fall accentuated by the unwinding of speculative positions. Whatever the cause, the benefits to commodity importing economies around the world are considerable and inflation fears have largely retreated. Our expectation is that inflation will stay subdued through 2009-10 and is unlikely to be a troubling factor for the foreseeable future.

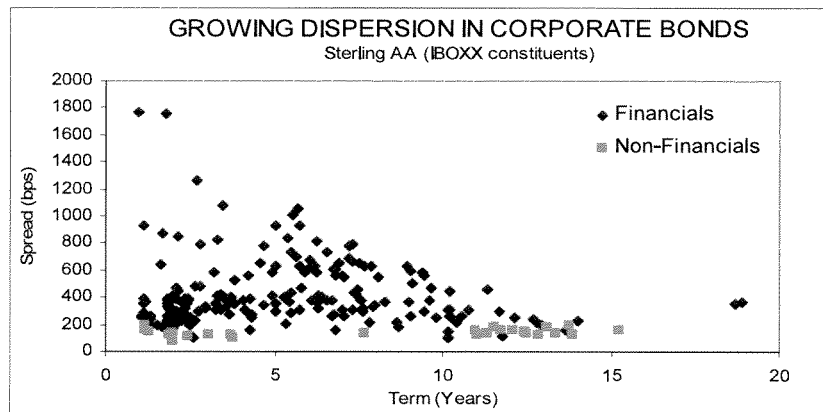
### Index-linked gilts more attractive

Subsiding inflation fears have caused a readjustment in the prices of index-linked gilts, seen in a significant rise in real index-linked gilt yields. There is considerable fluctuation day to day but valuations on these inflation protection instruments have, on the whole, been meeting our "fair value" hurdle rates. The move in index-linked gilts has been favourable relative to inflation swaps, making "physical" index-linked gilts a lower cost means of securing inflation protection. Overseas inflation protection costs remain much lower than in the UK across both swaps and physical bonds so this is a worthwhile alternative to investigate. Our specialist teams would be happy to provide advice in this area.

Fixed interest gilt yields have been very volatile. Periods of acute risk aversion, such as we see at the time of writing, have periodically taken yields down into expensive territory. However, the expectation of higher gilt issuance following the announced expansion of direct banking sector support is pulling in the opposite direction, making an opportunistic approach necessary.

### Credit spread movements opening up opportunities

The further rise in corporate bond spreads since September has been accompanied by growing dispersion in spreads on investment grade bonds (see chart). This throws up two observations. First, we believe actively managed credit mandates now have added room to exploit this dispersion and pricing anomalies to generate higher returns. Second, we are concerned that the relatively limited damage to non-financial corporate bonds thus far may not last if worsening credit quality in economies at large puts upward pressure on these issuers. However, for investment grade as a whole we believe that current spreads are attractive, though we would still keep some ammunition in reserve for better buying opportunities.



### Dividend yields not enough reassurance for equities

High uncertainty over the outlook for corporate profits is holding equity markets back even though valuations have looked reasonable for some time. One valuation measure commonly used in recent months to present a strong valuation case for equities has been the dividend yield, the ratio of dividends paid in the past year to current share prices. The current dividend yield in the UK market, at over 6%, is well above the long-term average yield of 4% and much above the norms of the past decade. The difficulty is that though dividends are less volatile than company profits, they can and do get cut in recessions. Over a third of dividends in the UK in 2007 originated from the financial sector. Eliminating dividends from UK banks could alone cut the dividend yield by upwards of 0.5%. More non-financial companies have also been cutting back dividends recently.



**Underweight equities but less so**

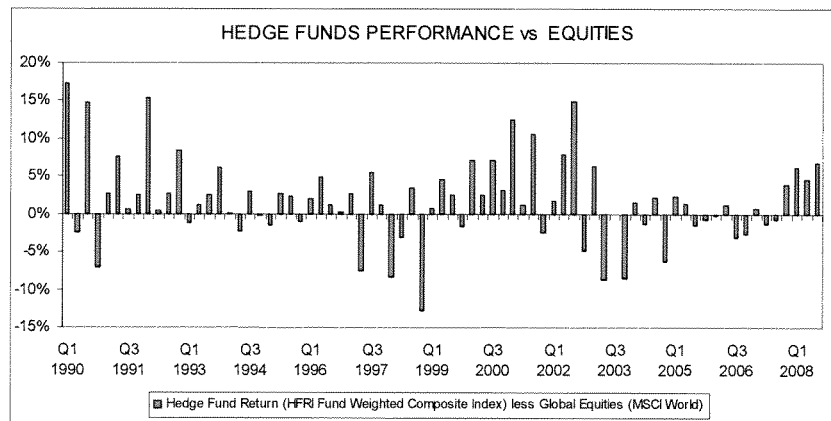
At the time of writing, we continue to hold a negative stance on equities. However, we have been using falls in markets to advise adding to equity positions where clients are well below their normal equity exposure. The risk of a catastrophic breakdown in equity markets that might have resulted from complete policy failure in the credit crisis arena has been averted. We also recognise the undoubted improvement in valuations. However, high risk aversion and the likelihood of continued negative news on growth and earnings are likely to keep markets on the defensive.

**Property bargains in the offing?**

Property values have fallen further than the standard indices would suggest. Limited transaction volumes and the lag between sale prices achieved and their capture in the indices are deterrents to obtaining an accurate gauge of market conditions. As with equities, the time for taking a more positive stance on property has come nearer and our property team is on the lookout for opportunistic purchases on the back of distressed selling. However, except in these special circumstances it is still too early to consider adding to property.

**Hedge funds: restating the case**

Hedge funds have hit the headlines, both as the supposed perpetrators of financial destruction and in terms of their performance which has not matched their "Absolute Return" badge – positive returns even in falling markets. A major issue has been a need to close many of their investment positions as prime brokers reduced the availability of credit to hedge funds and as they prepared for an onslaught of redemptions. This has led to forced sales into unreceptive markets.

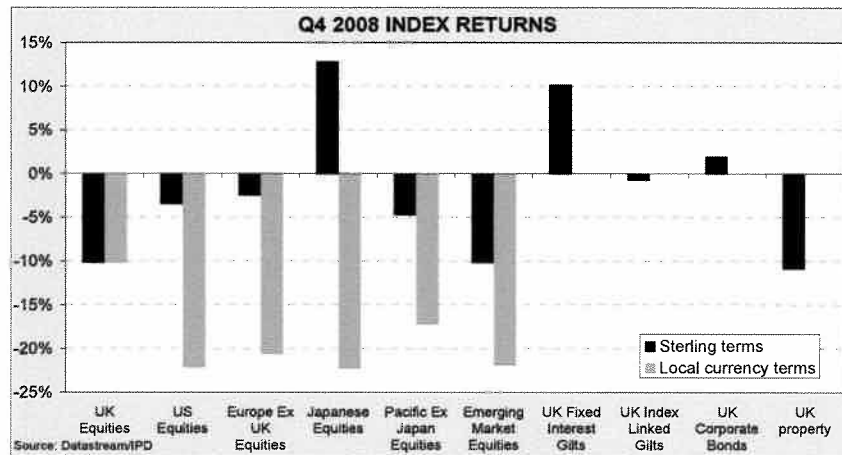


We would make the point that this de-leveraging is a one-off, by its nature it will not be repeated. Also the truly "market neutral" strategies which we have been recommending have fared better than the hedge fund strategies which were little more than leveraged views on credit or some other directional bet. Finally, hedge funds have outperformed other return-seeking asset classes such as equities. So, while we do not hide our disappointment, we believe the case for hedge funds is undiminished.

## Appendix 2 – Quarterly Investment Outlook January 2009

### Summary

- Numerous aggressive policy initiatives will not prevent economic growth from continuing to fall until the second half of 2009.
- Fixed income gilts are too expensive, credit spreads are too high and derivatives are expensive compared to their "physical" counterparts.
- Expectations for corporate profits are still too high and likely to prevent longer term value in equity markets being recognised for the time being.
- The fallout from the credit crisis is a setback to hedge funds and infrastructure. Opportunities in property and possibly commodities may well emerge later in the year.

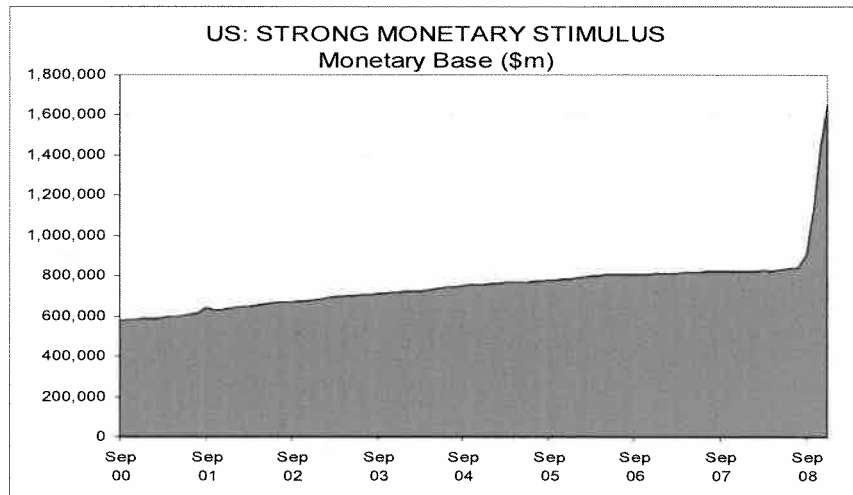


### Loss of confidence and economic woes hit equity markets

The uncertainty of policy surrounding the collapse of Lehman in September 2008 led to a multitude of policy initiatives in the final quarter of the year as described below. Unfortunately policymakers always seemed to be behind events and the major overseas equity markets fell by 20% or more as the economic repercussions of the financial crisis became evident. The saving grace for UK investors was the collapse in sterling which mitigated the falls when expressed in sterling. Nonetheless, UK equities and property both fell sharply. Only fixed income government bonds performed strongly in a flight to safety.

### Aggressive policy stimulus to revive economies

Since October, policy-makers have been on the offensive to limit the economic repercussions of the credit crisis. Aggressive interest rate cuts, recapitalising banks and guaranteeing debt have come together. The US monetary base (the sum of commercial banks' reserves with the US Federal Reserve and notes and coin in circulation) has risen very sharply, indicating the strength of monetary stimulus (see chart). Large fiscal stimulus will also come through in the next few months under the new Obama administration. In the UK, the thrust of policy has been similar. Though the monetary base has not risen as fast (a 25% rise compared to the doubling seen in the US), a 3.5% cut in UK base rates in only a little over 3 months is also a dramatic easing in monetary policy.



**Economies should stabilise by year end**

The key questions are whether this policy stimulus will work, and how soon. While we are not in the pessimistic camp which believes that policy action will fail, some measures may not succeed if consumers focus on reducing their debt. Nevertheless, the weight of these varied policy measures should still make a difference eventually. If, as we expect, economies stop shrinking sometime in the second half of this year, it will still have been one of the most severe and globally coordinated recessions in post-war history.

Forecasts used by the US National Bureau of Economic Research suggest that the US recession is likely to be much longer than the 11 month average since 1945, and the envisaged drop in output will only be exceeded by the recession of the mid 1970s. We expect the UK economy to show a similarly extended downturn, reflecting its strong exposure to the financial sector and high household debt. Globally, though every region is affected, fewer obvious financial imbalances should result in recessions of shorter duration in the Eurozone and Japan.

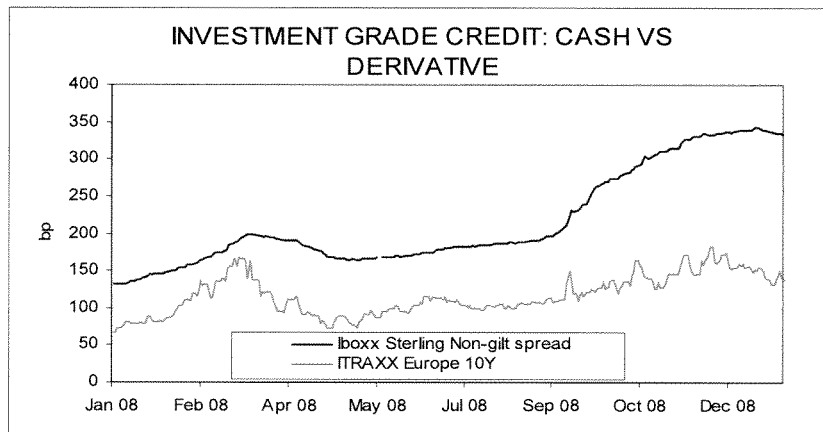
**Gilts: yields too low**

The credit crisis and its aftermath of sharp commodity price falls have clearly lowered the likely inflation path for the next 1-2 years, but this should not have a marked impact on the long-term. Indeed, with monetary stimulus of the kind seen recently, the risk of a lasting period of higher inflation is as much of a risk as policy measures failing and economies entering into deflation. Our long-term UK inflation assumptions see a period of low inflation, followed by a reversion to Bank of England targets.

Many commentators have argued that the fall in break-even inflation rates (the difference in yield between index-linked gilts and fixed income gilts of equivalent duration) are signalling very low inflation or even deflation. However, these break-even inflation rates can be an unreliable guide to long-term inflation expectations, especially recently, when they have been so influenced by the flight to safety into fixed gilts which has driven yields down to highly unattractive levels.

**Low gilt yields go with high spreads on corporate bonds**

It is not surprising that gilts have become expensive at the very time that corporate spreads have risen so rapidly. Recession fears are behind both. Much as gilt yields may have fallen too far, our view is that corporate bond spreads have moved too high. We believe that these spreads are likely to be slow to move back. Nonetheless, this is still a good opportunity to switch from gilts to corporates. With underlying gilt yields lower in recent months, however, absolute return potential has weakened.



**'Physical' preferred to derivative**

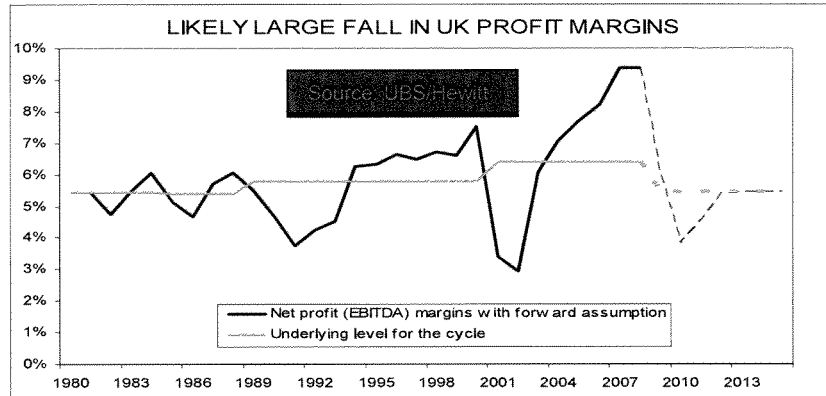
The credit upheaval has resulted in a scarcity of capital, making the market in credit, interest rate and inflation derivatives less efficient. This has improved the case for 'physical' relative to derivative exposures in these areas. In credit markets, we prefer credit exposure to be gained through the 'cash' corporate bond market rather than credit default swaps (CDS), where spread levels have not moved upwards to the same extent (see chart). With gilt yields already unattractive, interest rate (fixed to floating) swaps appear worse value owing to swap rates being below gilts for longer durations. Likewise, lower cost inflation protection is currently achieved through the physical index-linked market. High volatility across the board means that timing and implementation are critically important.

**Protection against a rise in sterling now worth considering**

Our assessment is that the sharp fall in sterling has only brought it back to "fair value". Negative factors such as the UK's exposure to the financial sector and a large current account deficit remain. Nevertheless, it would now be wrong to bet on sterling falling much further. Pension funds with large unhedged overseas investments should now consider hedging some of the currency exposure from a strategic perspective.

**Equities: profit margin squeeze**

Corporate earnings are now falling. There are two aspects to how this affects equities. First, the recession is causing a sharp *cyclical* downturn in earnings. If, as we expect, profit margins fall to levels seen in the last two profit downturns, earnings could fall in excess of 50% over the next two years. Secondly, there is a *secular* aspect to profits. Once the cyclical downturn ends, we expect the subsequent profit recovery to be relatively weak. This implies a downward shift in the secular or underlying trend in profitability. Our working assumption for the UK is that profit margins revert back to levels seen in the 1980s rather than those of recent cycles, a result of a changed economic and financial environment. This margin profile (see chart) suggests that the large earnings contraction will be followed by modest recovery. The US should follow a similar path, but there is reason to believe that the secular uptrend seen over the past decade in Europe and Japan may not erode to quite the same extent.



**Equity valuations not enough of a draw**

These earnings paths – well below average market expectations, make equity market valuations appear less obviously cheap in our models. Against expensive gilts, equities continue to look good, but this may not be sufficient for equities to perform if markets start to move longer-term secular earnings expectations closer to our own. We would advise buying only for those clients substantially below their normal equity exposures.

**Fallout from credit crisis hits hedge funds and infrastructure**

Hedge funds suffered badly last quarter as the credit available to hedge funds was reduced, leading to de-leveraging and forced sales of assets. The Madoff scandal also accentuated redemption requests. Some strategies have been badly hit by their sensitivity to market levels and credit spreads – these are the strategies we have warned against and it is notable that other strategies such as Global Macro produced positive returns over 2008. In the short term, the redemption schedule will dominate but once fundamentals re-assert themselves over technical pressures, managers should again deliver attractive risk adjusted returns.

The many reasons for investing in infrastructure remain – high stable income, inflation linkage, an opportunity set which will now be enhanced by an emphasis on infrastructure in fiscal stimulus plans. However, returns from infrastructure investments are heavily influenced by the cost of credit which has soared. This is less serious for existing funds which have locked in their cost of debt than for new investments which face significantly increased funding costs. This leads us to recommend holding back from investing in infrastructure at this time.

**Looking for opportunities in property and possibly commodities**

Following the collapse in property prices, rental yields have risen to attractive levels, even after factoring in falls in rental values over the next few years. However the anticipated newsflow and supply/demand considerations mean that we would not jump in quite yet. Similarly, although commodity prices have collapsed and in many cases are now around the cost of production, the deteriorating economic outlook points to deferring any investment.

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