



Haringey Council

Agenda item:

Pensions Committee

On 18/06/09

Report Title. **Quarterly 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 review the Fund's asset allocation position.

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.

<p>4. Recommendation</p> <p>4.1 That changes to the Fund's Asset Allocation position be considered.</p>
<p>5. Reason for recommendation</p> <p>5.1. Our external investment advisors, Hewitt, advise that value can be gained by making some changes to current asset allocation.</p>
<p>6. Other options considered</p> <p>6.1. None.</p>
<p>7. Summary</p> <p>7.1. This report considers the latest Asset Allocation advice received from the Fund's external investment advisors. This will be updated further at the meeting taking account of up to date market data and views.</p>
<p>8. Head of Legal Services Comments</p> <p>8.1. The Head of Legal Services has been consulted on the content of this report and comments that that the Committee should give full consideration to the financial advice received concerning the changes to current asset allocation. Members are reminded of the duty on an administering authority to conduct a coherent overview of investment activity and performance of the Pension Fund in order to ensure the suitability of investments and types of investments.</p>
<p>9. Equalities & Community Cohesion Comments</p> <p>9.1. There are no equalities issues arising from this report.</p>
<p>10. Consultation</p> <p>10.1. Not applicable.</p>
<p>11. Service Financial Comments</p> <p>11.1. The Pension Fund receive Hewitt's quarterly active asset re-balancing proposals as produced by their Asset Allocation team. The cost includes presenting these proposals at meetings of Pensions Committee.</p> <p>11.2. The cost of the quarterly investment outlook updates should be more than</p>

offset by additional performance returns made by the Fund by following an active asset re-balancing strategy.

12. Use of appendices /Tables and photographs

12.1. Appendix 1 - report by Hewitt.

13. Local Government (Access to Information) Act 1985

13.1 Update on Asset Allocation issues report and presentation by Hewitt to Pensions Committee on 29 January 2009.

Background

14.1 Pensions Committee on 30 April 2009 considered a report on Asset Allocation and agreed that:

- an active asset allocation rebalancing strategy be introduced on a quarterly basis;
- that the asset allocation review service be provided by Hewitt and that the budget be amended to reflect this;
- that decisions be delegated to the Chief Financial officer in consultation with the Chair of Pensions Committee, if any asset allocation changes need revising urgently in between quarterly meetings of Pensions Committee;

14.2 The first Quarterly Asset Allocation report is appended from the Pension Fund's external investment advisors. This report gives an executive summary, quarterly investment outlook and the April market update.

Quarterly Asset Allocation review

14.3 Hewitt's report shows the Fund's asset allocation and benchmark weightings as at 30 April 2009 as provided by the Custodian, Northern Trust. Summary numbers are as follows. The last column shows Hewitt's suggested range.

	Actual allocation as at 30/04/09 %	Benchmark %	Suggested range %
UK equities	26.2	30.5	25 – 30
Overseas equities	37.2	34.5	30 – 40
UK gilts	8.1	7.0	0 – 10
Index linked gilts	7.0	6.0	0 – 20
Corporate bonds	11.0	7.0	0 – 15
Private equity	3.5	5.0	2 – 5
Property	5.1	10.0	5 – 15
Cash	1.8	0	
Totals	100.0	100.0	

14.4 Hewitt assume that inflation will be moderate in the longer term but there is a risk of extreme inflation scenarios due to the policy making environment. Rising gilt market volatility and large fluctuations mean that the timing of hedging liability risks is critical. Hewitt continue to prefer corporate bonds relative to gilts and believe that they will perform better ahead of the sustainable equity market gains. Opportunities to purchase property are anticipated for later this year.

14.5 The April market update shows that equity markets continued to rally across the world in April. The strongest local currency performance came from european equities and the highest in sterling terms were in emerging markets. Interest rates remain at historic lows in the world. The first purchases of government bonds by various quantitative easing schemes took place in April. Yields on fixed gilts fell a little for short term but increased for medium to long term. Yields on index linked gilts fell for the short term and rose for medium to long term. Property prices continued to fall in March.

14.6 Hewitt advise that:

- no changes are made in equities weightings given continuing market turmoil and due to no clear evidence that the worst is behind us;
- Corporate bonds are preferred to gilts and recommend a further increase in the Fund's exposure to corporate bonds;

- no changes are recommended for property although it is recommended that ING are contacted regarding their views on the market and the outlook for property opportunities later this year;
- the Fund's Private equity allocation should not be changed;
- the introduction of active currency should be considered with a view to funding with Investec in the not too distant future.

Conclusions

- 14.10 Hewitt have provided their latest Quarterly Asset Allocation review report as appended. The report makes recommendations for considering changing the Fund's current asset allocation with suggested ranges for asset allocation also given.
- 14.11 Hewitt will attend Pensions Committee and give specific recommendations taking account of up to date market data.

Asset Allocation Report - May 2009

London Borough of Haringey

The Hewitt logo consists of the word "Hewitt" in a white, sans-serif font, centered within a solid black square.

29 May 2009

Prepared for
Pensions Committee

Prepared by
Hewitt Associates Limited

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Executive Summary

Investment Outlook

We assume inflation will be moderate in the longer term but recent policy action has raised the possibility of extreme inflation scenarios.

Rising gilt market volatility and large fluctuations in break-even inflation rates mean that the timing of hedging liability risks is critical.

We continue to like corporate bonds relative to gilts and believe they will perform better ahead of sustainable equity market gains.

The operating environment for hedge funds is stabilising and we favour Convertible Arbitrage and Distressed Debt strategies.

We anticipate that there will be opportunities to purchase property later this year.

Asset Allocation, Fund Benchmark & Manager Exposure

The Fund's actual asset allocation and benchmark weightings as at 30 April 2009 (the most up to date information available from Northern Trust) are shown in the table below:

	Value £m	Total %	Bmark %	Suggested Range
UK Equities	126.4	26.2	30.5	25 - 35
Overseas Equities	179.9	37.2	34.5	30 - 40
UK Gilts	39.3	8.1	7.0	0 - 10
Index Linked Gilts	34.0	7.0	6.0	0 - 20
Corporate Bonds	53.4	11.0	7.0	0 - 15
Private Equity	17.1	3.5	5.0	2 - 5
Property	24.5	5.1	10.0	5 - 15
Cash	8.7	1.8		
Total	483.3	100.0		-

What this means for the Fund

Equities – given the continuing market turmoil, and the fact that there is no clear evidence that the worst is truly behind us, we recommend that no change is made to the equity weighting at this time.

Bonds – we continue to prefer Corporate Bonds over Gilts, and so would recommend a further increase in the Fund's exposure to Corporate Bonds.

Property – we believe that opportunities will come later in the year, and suggest that the Fund ask ING for an update on their views of the market, and their outlook for property later in the year

Private Equity – we do not believe that the Fund's private equity allocation should be increased at this time

Currency – we suggest that the Fund considers again whether Investec – who were selected as currency manager almost two years ago - should have their mandate funded at some point in the not too distant future.

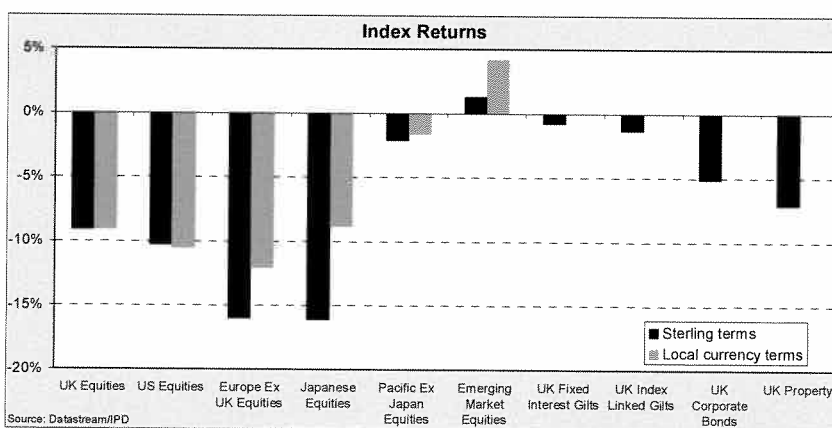
We look forward to discussing the detail of the suggested actions above at the Committee meeting on the 18th June 2009.

Quarterly Investment Outlook

Summary

- We assume inflation will be moderate in the longer term but recent policy action has raised the possibility of extreme inflation scenarios.
- Rising gilt market volatility and large fluctuations in break-even inflation rates mean that the timing of hedging liability risks is critical.
- We continue to like corporate bonds relative to gilts and believe they will perform better ahead of sustainable equity market gains.
- The operating environment for hedge funds is stabilising and we favour Convertible Arbitrage and Distressed Debt strategies, with the latter being something suggested by the Fund's independent advisor some time ago.
- Since the Haringey Pension Fund already has a property manager in place, our general advice that we are giving to clients to begin selecting property managers now is not relevant. What underpins this advice is our belief that there will be buying opportunities in property later on in the year.

Q1 2009 Index Returns



A quarter of two very different periods

January and February saw equity markets collapse as investors became alarmed over bank nationalisations and the depth of the recession. In February, risk aversion was all too evident in falling bond yields and strength in the dollar and yen, both seen as safe haven currencies. March saw sentiment change dramatically on the back of action from policymakers and tentative green shoots of economic recovery, or rather a slower rate of deterioration in global economic growth. The more positive tone has continued into April but we do not believe it is sustainable.

Is the policy environment creating inflation risks?

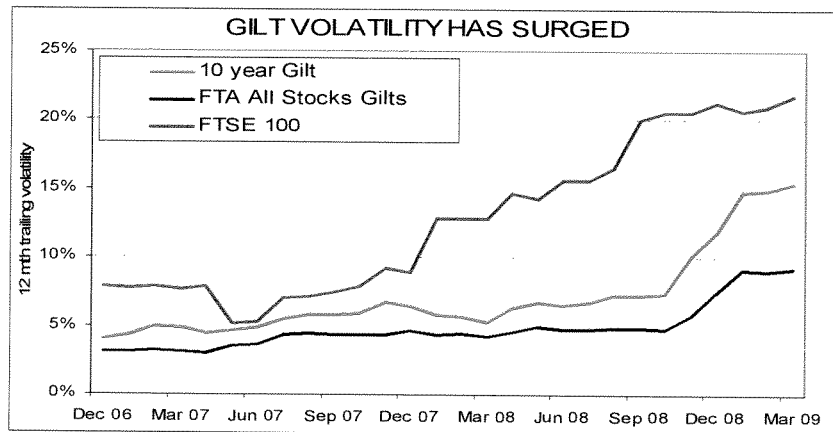
The rapid contraction in global economic activity seen since the middle of last year is now being countered by reflationary policy in its strongest form – a direct and deliberate attempt to push up the quantity of money in the economy. Quantitative easing (QE) has already begun in the US, UK and Japan. Though the European central bank has held back so far, there is a widespread view that it is preparing to implement QE. Coming after the earlier move to zero interest rates and a large expansion of budget deficits, QE is giving rise to fears of an eventual upsurge in inflation once the deflationary impetus of the economic downturn has played out. However, inflation risks may not all be to the upside. By fully exhausting the policy armoury to aggressively combat the downturn, any failure to revive economic activity carries the risk that confidence is dented further,

entrenching deflation as both prices and wages fall.

Our view is that the policy-making environment has raised the risk of extreme inflation scenarios – sustained outright falls in prices or inflation levels above 5%. Normally described as 'tail events', these should now be thought of as scenarios with significant probabilities. That said, we are still most likely to avoid these extremes, although the higher risk of extreme inflation scenarios needs to be recognised.

Gilts become volatile

The advent of quantitative easing in the UK led many to predict a large fall in gilt yields, but this has not happened. Rather, worries over inflation and issuance have combined to substantially raise gilt market volatility. This is a relatively new development compared with equity markets where high volatility has endured for nearly two years (see chart).



Large fluctuations in break-even inflation rates, the difference in yields between conventional and index-linked gilts of equivalent duration, have also become more evident. Break-even rates are used in the market as an indicator of expected inflation, although they are heavily influenced by gilt supply and demand trends, which have recently seen major changes. Whatever the driving factor, however, volatility in break-even inflation rates should provide opportunities to hedge risks at reasonable valuations, though timeliness is essential.

Corporate bond doldrums

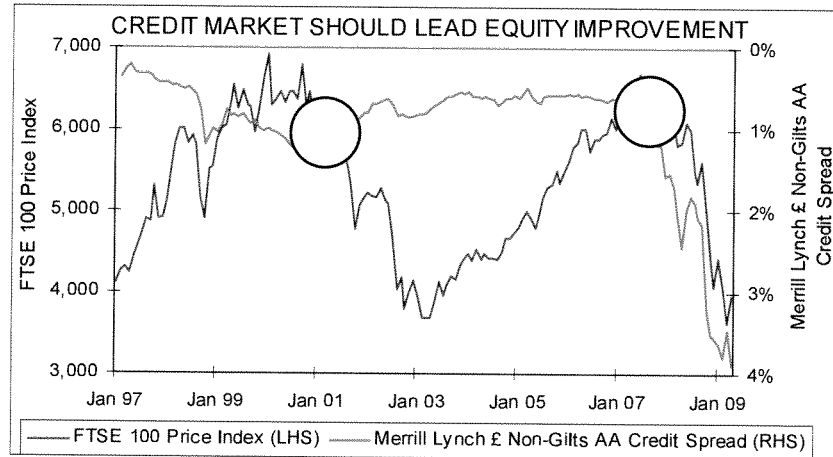
We have yet to see an improvement in the market's perception of credit risks in corporate bond markets. Investment grade corporate bond spreads (the difference in yields between corporate bonds and gilts of equivalent duration) have remained at very high levels. The first quarter's marginal increase in spreads over gilts was entirely due to the financial sector, where concern over subordinated debt remained, even after partial banking sector nationalisation and the extension of debt guarantees over a portion of the banking sector's liabilities.

Notwithstanding the further upward creep in spreads seen this year, we continue to see corporate bonds as attractive, particularly relative to conventional gilts. Our view is that the high spreads of recent months more than compensate for the inevitable surge in defaults and downgrades over the next few years. Attractive valuations, alongside our unchanged expectation that economic conditions will improve gradually in 2010, suggest that spreads should decline significantly in the medium-term.

Equities vs corporate bonds

Equities have staged a sharp recovery from their early March lows. Emerging markets have, year to date, even shown positive returns, against our expectations of continued relative underperformance.

Optimism that policy makers will succeed may have been partly responsible, as well as support from rising commodity prices.



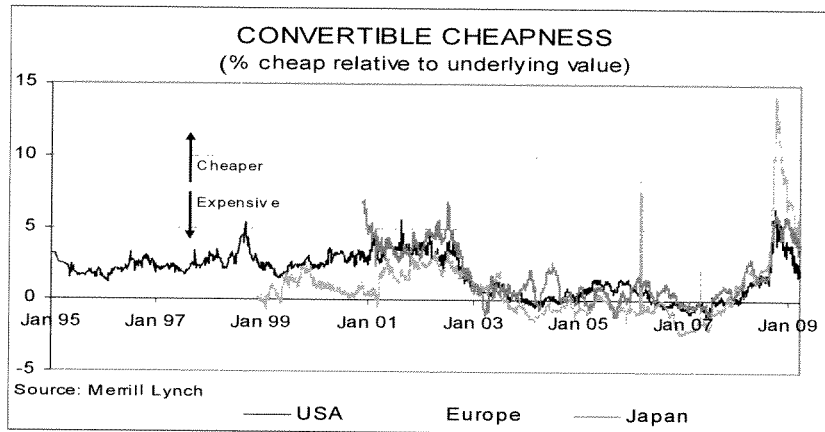
However, this equity market recovery has occurred without a significant improvement in credit market conditions, a factor that casts doubt on the sustainability of the current rally. We have generally seen that credit market improvement has led, to a greater or lesser extent, equity market turning points for at least a decade (see chart). This expectation of credit leading equity markets should be stronger when the world is emerging from a credit crisis. Other timing factors are also not supportive of a new bull market. For example, demand for equities is weak relative to supply.

Equities: still no rush to buy

Equity valuations are reasonable rather than highly attractive, once our corporate profitability assumptions are applied. Taken alongside the lack of support from the equity timing factors raised above, our stance on equities remains cautious. We stay on the sidelines, sceptical of the recent market recovery, viewing it as another one of those rallies that typically punctuate bear markets. That said, the duration and depth of the bear market has reached levels at which the risk of taking a very bearish view has increased. Our earlier advice of using market setbacks to rebalance towards a less negative stance is unaltered.

Convertibles and Hedge Funds

During the second half of 2008 Convertible Arbitrage funds, more than most hedge funds, faced a liquidity squeeze and needed to sell assets to meet redemption payments. This forced selling drove down convertible prices below the sum of their component parts (a straight bond with the same maturity and credit risk as the convertible and an equity option). Convertible Arbitrage hedge funds appear to offer a good way to access this opportunity, even though value anomalies are less extreme than a few months ago (see chart).



We continue to like other hedge fund strategies, in particular the Distressed Debt and Global Macro strategies. We believe the opportunity set for hedge funds is large and competition from the trading desks of banks has diminished as banks have greatly tightened the reins on their traders. With redemptions now probably past the worst, a more normal operating environment for hedge funds is being restored.

Commodities

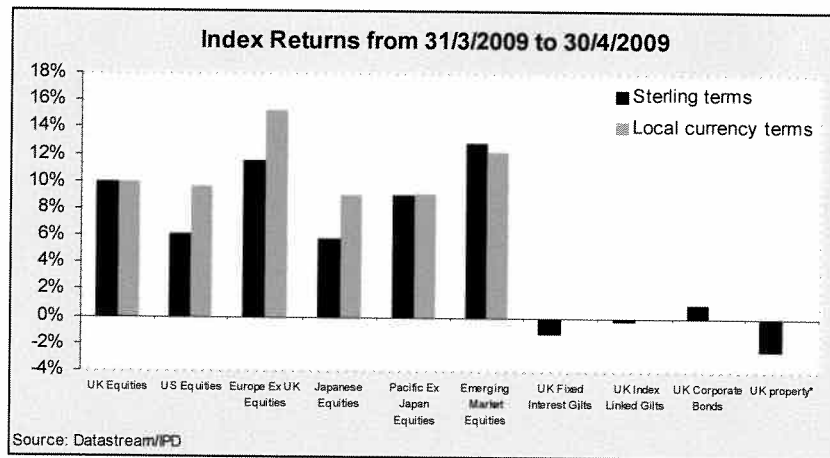
Commodities have been much in the press recently, with a lively debate on whether a brighter outlook beckons after last year's large negative returns. Those worrying about the longer-term inflation risks resulting from central bank policies also argue for commodities as inflation hedges.

As always, it is worth disentangling commodity return prospects into the outlook for prices and roll yields - the positive (or negative) return accruing as expiring futures are rolled into lower (or higher) priced new ones. The outlook for roll yields remains poor, given upward sloping futures curves (called contango in commodities markets.) Commodity prices, however, are now at or close to their marginal cost of production, though weak demand is still likely to constrain prices. Overall, even after taking any inflation hedging benefits into account, this is still a weak valuation story.

Get ready for property

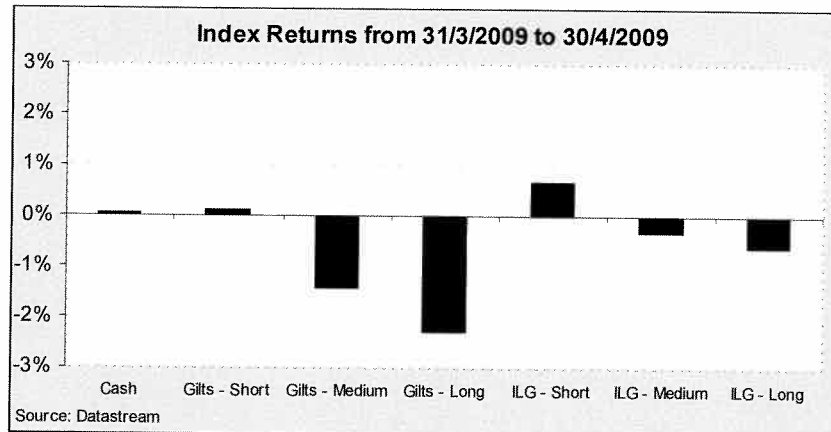
It was another bad quarter for property and there is worse to come for the IPD index which lags actual market transactions and so is overstating true property values by perhaps 10%. The good news is that rental yields have now reached 8% and the largest property companies have successfully refinanced in the equity market. While further falls in property prices are anticipated, we believe we are now at the stage when clients who do not currently have an existing property manager should be selecting managers ahead of investment opportunities later this year. As already mentioned, this last point does not apply directly to the Fund, since ING are already in place.

April Market Update



* Property relates to February 2009 to March 2009

- Equity markets continued to rally across the world in April. The strongest local currency performance came from European equities and the highest in sterling terms from Emerging Markets.
- Interest rates remain at historic lows across the world. The first active purchases of government bonds by various QE schemes were seen in April.
- The UK budget statement showed record amounts of new gilt issuance planned for this financial year.



- Yields on fixed gilts fell marginally for short term but rose for medium to long-term maturities as fears about new issuance dominated the space. Yields on index-linked gilts also fell at the short end and rose across the medium to long end.
- Investment grade spreads have remained at multi decade highs, but began to fall through April.
- Property prices continued to fall in March.