Haringey Council

Agenda item:

Pensions Committee	On 17 September 2009

Report Title. **Quarterly Asset Allocation review**

Report of **The Chief Financial Officer**

Signed :

Contact Officer : **Colin Duck – Corporate Finance**
Telephone 020 8489 3731

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.

4. Recommendation

4.1 That the Fund's Asset Allocation position be noted.

5. Reason for recommendation

5.1. Our external investment advisors, Hewitt, advise no further changes be made to current asset allocation at this stage.

6. Other options considered

6.1. None.

7. Summary

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.

8. Head of Legal Services Comments

8.1. The Head of Legal Service 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 recommendation on 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.

9. Equalities & Community Cohesion Comments

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

10. Consultation

10.1. Not applicable.

11. Service Financial Comments

11.1. The Pension Fund receive Hewitt's quarterly active asset re-balancing proposals as produced by their Asset Allocation team at a cost of £30k per annum. This cost includes presenting these proposals at meetings of Pensions Committee.

11.2. The cost of the quarterly investment outlook updates should be more than

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 At the 18 June meeting of Pensions Committee, following consideration of Hewitts first quarterly Asset Allocation report it was agreed that a 2% switch be made from conventional gilts to corporate bonds. That switch (equivalent to £9.95m) was made on 6 August 2009 within Fidelity's fixed income portfolio.

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

Quarterly Asset Allocation review

14.4 Hewitt's report shows the Fund's asset allocation and benchmark weightings as at 30 June 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 30/06/09 %	Benchmark %	Suggested range %
UK equities	27.1	30.5	25 – 30
Overseas equities	36.3	34.5	30 – 40
UK gilts	7.9	7.0	0 – 10
Index linked gilts	7.5	6.0	0 – 20
Corporate bonds	11.9	7.0	0 – 15
Private equity	1.9	5.0	2 – 5
Property	6.4	10.0	5 – 15
Cash	1.1	0	
Totals	**100**	**100.0**	

14.5 Hewitt assume that inflation will be lower for the next few years but in the longer term there is a risk of higher inflation scenarios due to the central banks maintenance of utra – easy monetary stances. Inflation risks and large gilt issuance make current yields unattractive. By comparison, although corporate bond spreads over gilts have declined, Hewitts' are of the view they still represent a more attractive investment compared to gilts. However, no further switches from gilts to corporate bonds are recommended at present. Opportunities to purchase property are anticipated for later this year.

14.6 The June market update shows that equity markets continued to rally across the world although investors have looked for the 'green shoots' of economic recovery since March. Hewitt's view is that a durable economic recovery based on growing household spending, and business investment is unlikely before next year.

14.7 Hewitt advise that:

- no changes be made in equities weightings until realistic profit margins are fully reflected in valuations;

- Corporate bonds are preferred to gilts but no further adjustments are recommended at this time;
- no changes are recommended for property at present although Hewitts' remain convinced that opportunities will come later in the year for ING to make active purchases. They will advise on opportunities at the appropriate time.
- the Fund's Private equity allocation should not be changed.

Conclusions

14.8 Hewitt have provided their latest Quarterly Asset Allocation review report as appended. The report makes recommendations to maintain the existing asset allocation at present.

14.9 Hewitt will attend Pensions Committee and give specific recommendations, if necessary after taking account of up to date market data.

APPENDIX 1

Asset Allocation Report - August 2009
London Borough of Haringey

Hewitt

20 August 2009

Prepared for
Pensions Committee

Prepared by
Hewitt Associates Limited

Hewitt Associates Limited
Registered in England No. 4396810
Registered office: 6 More London Place London SE1 2DA

Contents

Executive Summary

Investment Outlook

We expect an inventory rebound to encourage investors looking for green shoots, but a genuine economic recovery is not yet in the offing.

It is too soon to become enthusiastic over equity market prospects and we are not adding to equity weightings at this time. Emerging market and small cap equity outperformance is not justified.

Inflation should head lower for the next few years, reflecting abundant spare capacity. Further out, risks shift towards higher inflation.

Corporate bonds remain more attractive than gilts, even as spreads continue to tighten. Inflation and issuance concerns suggest a need for continued caution on fixed interest gilts.

Within alternatives, we continue to like hedge funds and also believe that transactions prices in property are now nearing their floor.

Asset Allocation and Fund Benchmark

The Fund's actual asset allocation and benchmark weightings as at 30 June 2009 (using information provided by Northern Trust) are shown in the table below:

	Value £m	Total %	Bmark %	Suggested Range
UK Equities	131.7	27.1	30.5	25 - 35
Overseas Equities	176.5	36.3	34.5	30 - 40
UK Gilts	38.6	7.9	7.0	0 - 10
Index Linked Gilts	36.6	7.5	6.0	0 - 20
Corporate Bonds	57.7	11.9	7.0	0 - 15
Private Equity	9.1	1.9	5.0	2 - 5
Property	30.9	6.4	10.0	5 - 15
Cash	5.3	1.1		
Total	486.4	100.0	100.0	-

What this means for the Fund

Equities – we are still of the view that realistic profit margins are not being fully reflected in equity valuations, and so we continue to recommend that no change is made to the equity weighting at this time.

Bonds – the Fund has recently implemented a 2% move from Gilts to Corporate Bonds. We see no need for any further adjustment at this time.

Property – we remain convinced that opportunities will come later in the year, at which time we would look for the underweight position in property to be closed through active purchases by ING. We will advise on the source of funds at the appropriate time.

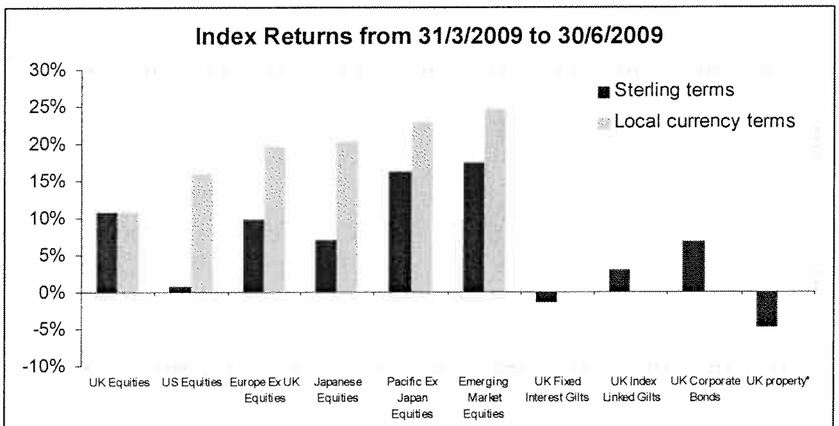
Private Equity – we do not believe that the Fund's private equity allocation should be increased at this time.

Quarterly Investment Outlook

Summary

- We expect an inventory rebound to encourage investors looking for green shoots, but a genuine economic recovery is not yet in the offing.
- It is too soon to become enthusiastic over equity market prospects and we are not adding to equity weightings at this time. Emerging market and small cap equity outperformance is not justified.
- Inflation should head lower for the next few years, reflecting abundant spare capacity. Further out, risks shift towards higher inflation.
- Corporate bonds remain more attractive than gilts, even as spreads continue to tighten. Inflation and issuance concerns suggest a need for continued caution on fixed interest gilts.
- Within alternatives, we continue to like hedge funds and also believe that transactions prices in property are now nearing their floor.

3 months to 30 June 2009



Source: Datastream/IPD

*Property return is 3 months to the end of May

Investors become much less risk averse

The strength in equity markets in March continued throughout April and May as encouraging economic indicators were released and as policymakers continued to be proactive in promoting growth. While there has subsequently been a small correction in equity markets, this has come later and from a higher level than we anticipated.

Other asset classes performed consistently with this less risk-averse attitude of investors: fixed interest gilts lost investors money, the safe haven Yen weakened and commodity prices rose sharply. The only exception was property, where illiquidity meant a lagging performance.

Inventory green shoots

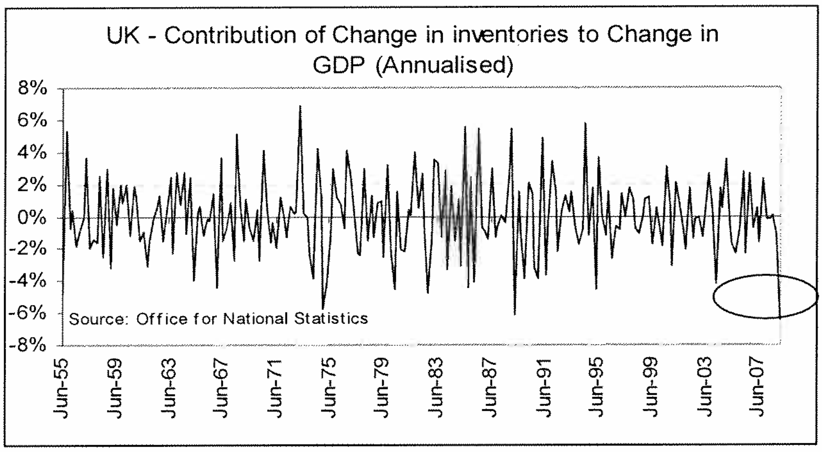
Investors have been on the lookout for 'green shoots' of economic recovery since March, when Ben Bernanke, the chairman of the US Federal Reserve, used the term to describe gradual improvement in US data.

Since then, a fair number of green shoots have been spotted in the US and elsewhere. However, this good news has been of the 'less negative' type, rather than positive signs of economic revival. More visible green shoots could soon be on the way. Fearing a collapse in demand, UK companies had slashed inventory around the turn of the year.

This resulted in a big hit to GDP growth, worse than that seen in the last recession of the early 1990s (see chart).

Now, as sales declines level out, inventories could be rebuilt. The magic of accounting for inventories, however, is that inventories could continue to be cut and economic growth would still be boosted, provided companies reduced them at a slower rate than before.

This boost to economic growth might reassure investors anxious for evidence of an economic rebound. The catch is that such restocking tends to only give a short-term boost to the economy before fading. Our view is that a durable economic recovery based on growing household spending and business investment is unlikely before next year.



Equities constrained by increased supply

Though the market rebound went over and beyond what we would have expected from a normal bear market rally, our view remains that we have not entered a new bull market.

NET SHARE ISSUANCE BY UK ENTITIES (£m, Bank of England data)

2005	2006	2007	2008	2009 to May
- 7,224	- 5,477	- 10,864	23,676	44,724

One factor which we believe will hold the market back is the supply of equity that is coming to the market. Banks have had to raise equity this year to boost regulatory capital ratios, but the increase in share issues is a broader trend.

UK equity market data shows that net equity issuance has turned sharply positive as companies are raising substantial new capital. This follows a period when the private equity boom and share buybacks had shrunk the amount of shares in issue (negative numbers for 2005-7 in table).

This increased supply of equity is likely to be a constraining factor on the market making further gains as it is not evident that demand for equities will rise in step with supply at higher market levels.

Emerging markets and small cap have run too hard

Economically sensitive emerging market and small cap equities have performed strongly in the equity market rebound. Emerging markets have recovered much of the ground lost in late 2008 supported by rising commodity prices and stronger economic data in China.

Our analysis, however, favours developed markets for the medium-term, based on the view that emerging market valuations suggest excessive optimism on how emerging economies and their companies will perform.

We also favour large capitalisation stocks over small.

Coming out of recession, small cap stocks have usually outperformed, but their relatively good performance throughout the recession now means that their valuation support is poor.

Not adding to equities

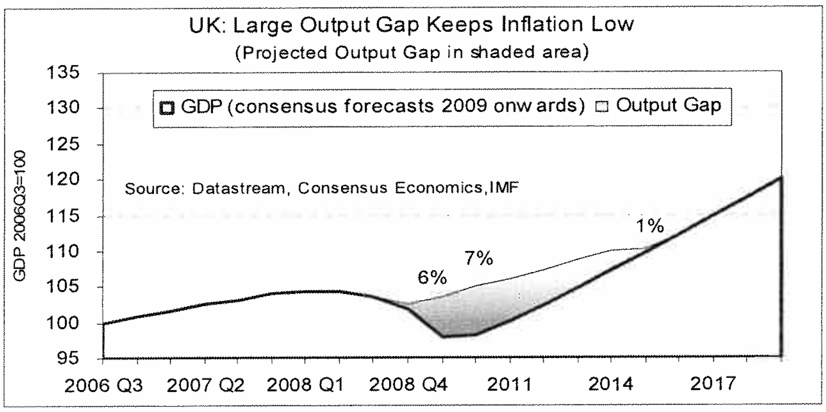
We remain on the sidelines in equities. The lack of strong valuation support in our models, our view that the compression of profit margins is incomplete and structural factors such as increased supply are behind our lack of enthusiasm.

We are alert to changes in market conditions that would move us towards taking a more positive 'buying' stance on equities, but at present, we are holding back from adding to equities. We anticipate opportunities to take a more positive view will arise in due course, at levels which should still be above the March market lows.

Inflation outlook particularly important

Inflation uncertainty has increased and is now having an important impact on all asset classes. Our research on the inflation outlook highlights strong pulls away from the moderate inflation path we have hitherto assumed.

Over the next two to three years, the extent of spare capacity opened up by the severity of the economic contraction suggests lower inflation. Output gaps, the difference between potential and actual output, are large, keeping inflation at bay (see chart). Underlying inflation could move towards zero in major economies.



Longer-term risk of higher inflation

Beyond the next few years, however, a pull towards the other extreme of significantly higher inflation is more likely. As economic recovery comes through, the large amounts of money that central banks have created will tend to feed through into the economy and push up inflation.

The inability or reluctance of central banks to exit their ultra-easy monetary stance in a timely way, at a time when politicians are more involved in economic policy, is the key risk to our long-term assumption of moderate inflation.

Corporate bonds preferred over gilts

Our view that risks are tilted towards higher inflation beyond the next few years suggests that investors in fixed interest gilts should demand a higher premium for bearing this additional risk. The climb in conventional gilt yields, despite large purchases by the Bank of England suggests that investors have indeed become more cautious.

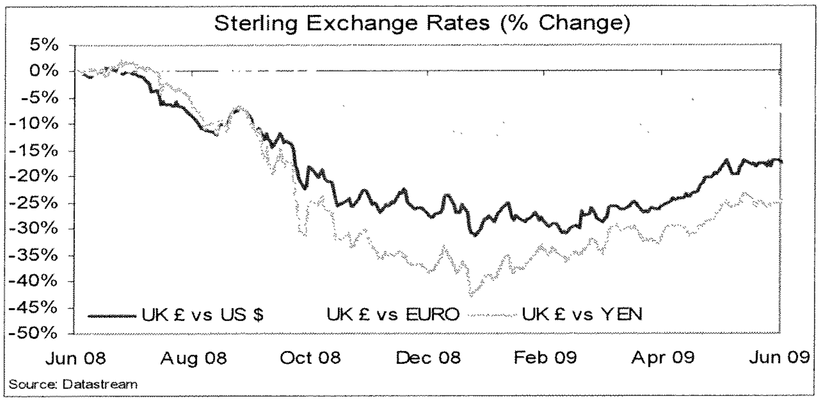
Inflation risks and large gilt issuance underpin our view that yields remain below our buying levels. Corporate bond spreads over gilts have declined sharply, but still leave corporate bonds looking attractive relative to gilts on our valuation approach.

However, the absolute attraction of corporate bonds is less attractive because the underlying gilt yields are not particularly appealing.

Sterling surges

Sterling rose sharply during the quarter, rising 15% against the dollar, but this must be seen in the context of the much sharper fall over the second half of 2008. Sterling's fall was driven by the loss of its traditional interest rate support, by a large external deficit and relatively high exposure to the weakening financial sector.

However, as we pointed out in December, by then the drags were either about to lessen or were priced in. Sterling surged once investors became less risk averse.



...and has gone far enough

Sterling is now close to the OECD's estimate of its long term purchasing power and with investors in our view somewhat ahead of themselves, we think a neutral stance on sterling is in order.

A mixed outlook in the "alternative investments" arena

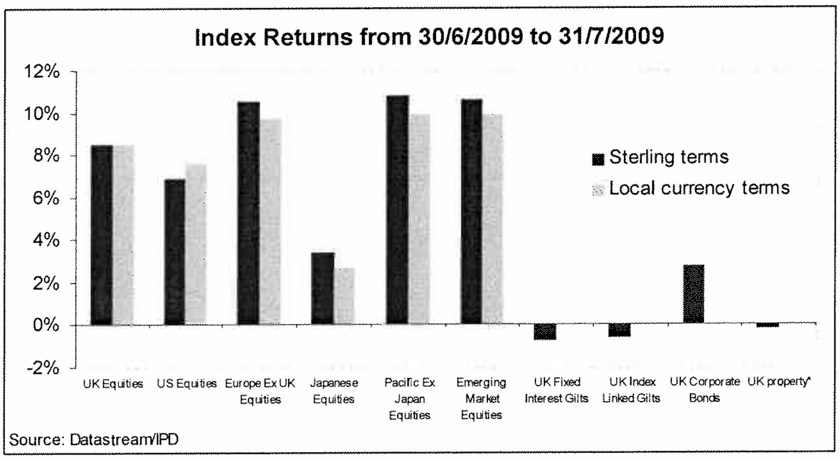
Turning to the so-called "alternative investments" arena:

Commodities performed very well, oil and copper prices rising 40% and 28%, respectively. However futures prices were well above spot prices, leading to a negative "roll return" (the return that results from rolling the current futures contract into the next one) and a smaller rise of 19% in the GSCI commodity total return index over this period. With this negative roll return still in place and the short term demand for commodities rather questionable, we believe it is premature to commit to this asset class.

Now that the massive redemption requests that hit hedge funds have largely been satisfied, we can expect a more normal steady sequence of returns. We remain positive on hedge funds.

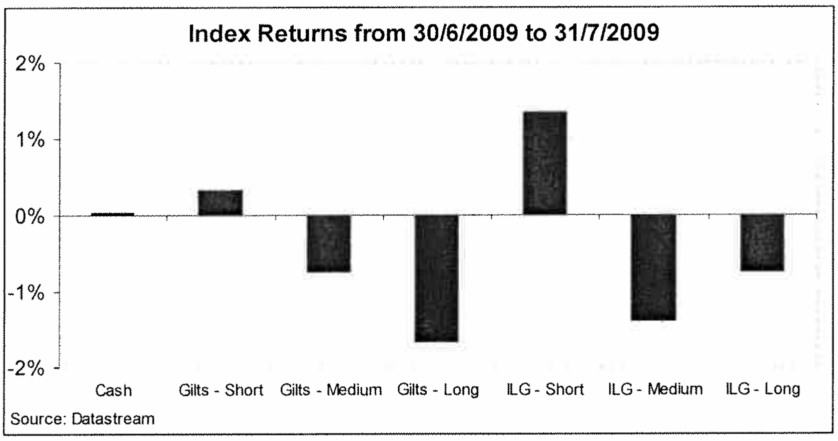
Property was the worst performing asset class. Its illiquidity and the valuation lag mean that true market prices are rarely reflected in indices. In our view, actual transaction prices should bottom later this year and we are suggesting to clients to get mandates lined up now to ensure timely investment. The Fund already has ING in place as property manager, and so the areas that need to be addressed are the timing and source of increasing funds for the manager, which we can advise on in due course.

July Market Update



Property relates to end of May 2009 to end of June 2009

- Equity markets across the world posted strong gains through the month. The best performance was in Emerging Markets, Japan lagged.
- Risky assets in general have performed well over the month on the back of a good start to earnings season and renewed economic optimism.
- Monetary policy continues to remain stimulatory but questions are beginning to surface over central banks exit strategies.



- Medium to long dated fixed interest gilt yields increased over the month, probably caused by investors returning to risky assets. Short dated conventional and index-linked gilts outperformed longer maturities.
- Property prices fell again in June (-0.2%), but the rate of decline in commercial property prices does appear to be slowing.
- Corporate Bonds returned 3% over the month as spreads continued to narrow. The spread on the Merrill Lynch Sterling Non-Gilt index decreased 60bps to 2.59% at the end of July.