Haringey Council

Agenda item:

Pensions Committee	On 01 December 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 changes to the Fund's Asset Allocation position be considered.

5. Reason for recommendation
   5.1 The Council's external investment advisors, Hewitt, advise that value can be obtained by making some changes to the current asset allocation.

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 receives 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.

14. 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. Hewitts now advise that the beneficial effect on the Fund of that switch based on unaudited data for the months of August, September and October amounts to approximately £500,000. Future reports will continue to monitor the performance of that decision.

14.3 The third 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 as at 30 October.

Quarterly Asset Allocation review

14.4 Hewitt's report shows the Fund's asset allocation and benchmark weightings as at 30 October 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 30/10/09 %	Benchmark %	Suggested range %
UK equities	33.2	30.5	25 – 35
Overseas equities	32.6	34.5	30 – 40
UK gilts	5.1	7.0	0 – 10
Index linked gilts	7.1	6.0	0 – 20
Corporate bonds	13.5	7.0	0 – 15
Private equity	3.1	5.0	2 – 5
Property	4.5	10.0	5 – 15
Cash	0.9	0	
Totals	100	100.0	

14.5 Hewitts view is that large injections of cash by central banks have strongly boosted markets but this beneficial effect is unlikely to be sustained as projected corporate earnings have overtaken reality in equity markets.

14.6 Although corporate bonds are still attractive compared to gilts little upside potential is seen in either asset class at present. Should inflation fears emerge consideration should be given to switching from fixed interest gilts to index-linked gilts.

14.7 Property valuations are attractive at present prices although caution should be exercised concerning the timing of further investments.

14.8 Concerning the Pension Fund Hewitt advise that:

- At present the equity weighting should be left unchanged,

- Holdings of corporate bonds and gilts should be reduced by 2% (equivalent to approximately £20m) and the proceeds retained in cash at present. Hewitt's recommend that this realised sum should be used to augment underweight property holdings through active purchases by the property manager at the appropriate time. Hewitts have discussed the timing of the property investment with ING (the funds property manager) who will determine the timing of the proposed switch into property. At present, a time horizon of approximately six months is likely. In the meantime, the switch from gilts and corporate bonds will result in a fall in income to the fund of approximately £400,000 (i.e. combined bond and gilt yields 5% minus money market earnings 1%). However, Hewitts are of the view that failure to effect the proposed switches in a timely manner could result in a significantly greater capital loss.

- the Fund's Private equity allocation should not be increased at present.

Conclusions

14.9 Hewitt have provided their latest Quarterly Asset Allocation review report as appended. The report makes recommendations for considering changes to the Fund's current asset allocation with suggested ranges for asset allocation also given.

14.10 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 - November 2009
London Borough of Haringey

17 November 2009

Prepared for
Pensions Committee

Prepared by
Hewitt Associates Limited

Hewitt Associates Limited
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Executive Summary

Investment Outlook

Optimism over economic recovery and the large injections of funds by central banks have strongly boosted markets, but this benign backdrop will not last.

After recent spectacular returns, corporate bonds look likely to take a breather, but they still look attractive against gilts.

Corporate earnings optimism is now overtaking reality. We expect this to be one of the drags on equity markets going into 2010.

Property valuations are attractive, although we would advise some restraint when investing in pooled funds where the commitment to the market is immediate.

Asset Allocation and Fund Benchmark

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

	Value £m	Total %	Bmark %	Suggested Range
UK Equities	185.2	33.2	30.5	25 - 35
Overseas Equities	181.5	32.6	34.5	30 - 40
UK Gilts	28.6	5.1	7.0	0 - 10
Index Linked Gilts	39.8	7.1	6.0	0 - 20
Corporate Bonds	75.3	13.5	7.0	0 - 15
Private Equity	17.4	3.1	5.0	2 - 5
Property	25.0	4.5	10.0	5 - 15
Cash	4.7	0.9		
Total	557.5	100.0	100.0	-

What this means for the Fund

Equities – whilst UK equities are slightly overweight, this position is broadly balanced by the slight underweight position in Overseas equities. Therefore, at this moment in time we are comfortable with leaving the equity weighting unchanged.

Bonds – Corporate Bonds have done very well in the last quarter, and Gilts are looking expensive. Our advice is to reduce each by 2%, holding this in cash for the moment. We recommend that these funds are made available to be invested in property.

Property – we remain convinced that opportunities will come, and we would look for the underweight position in property to be closed through active purchases by the property manager, using the cash raised from bonds.

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

Success of our advice so far

When putting the framework in place for providing the Fund with medium term asset allocation advice, it was agreed that we would monitor the advice implemented, and try to track the success – or otherwise – of the advice.

So far, there has only been once recommendation that has been implemented. We suggested that the Fund increase its exposure to Corporate Bonds, by reducing its exposure to UK Gilts. This advice was given at the end of July 2009, and arrangements were made with Fidelity to amend the Fixed Interest Benchmark to which they manage assets.

As a result, approximately £10 million was transferred from UK Gilts to Corporate Bonds in early August.

The unaudited returns for August, September and October, as stated by Fidelity, are as follows:

	August		**September**		**October**	
	Fund	**Bmark**	**Fund**	**Bmark**	**Fund**	**Bmark**
UK Gilts	4.05	3.67	0.82	0.18	0.01	-0.27
Corp Bonds	6.75	7.06	2.44	1.55	0.90	0.26

Therefore, for the three month period to end October UK Gilts returned +3.6%

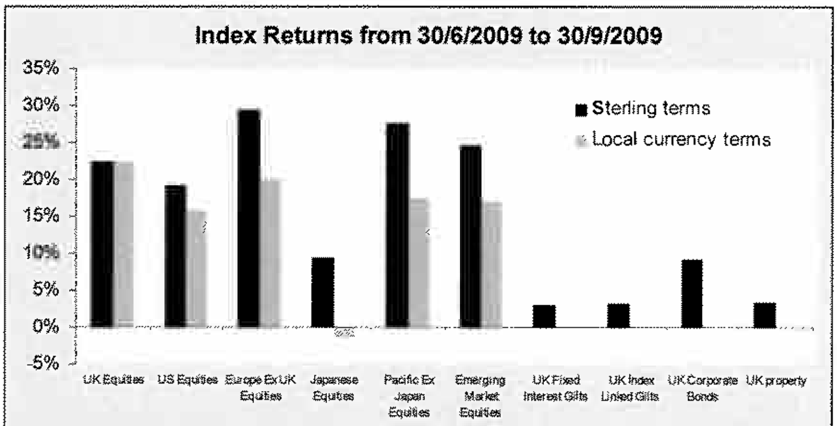
UK Corporate Bonds returned +9.0%

Using the returns shown above, the move from Gilts to Corporate Bonds generated an additional return of approximately £500,000 over the three months. Clearly this has been a beneficial asset allocation move for the Fund.

We will continue to monitor this move, and any future moves, on an ongoing basis.

Summary

- Optimism over economic recovery and the large injections of funds by central banks have strongly boosted markets, but this benign backdrop will not last.
- Inflation protection through index-linked gilts can be purchased on reasonable terms by switching from fixed interest gilts.
- After recent spectacular returns, corporate bonds look likely to take a breather, but they still look attractive against gilts.
- Corporate earnings optimism is now overtaking reality. We expect this to be one of the drags on equity markets going into 2010.
- Property valuations are attractive, although we would advise some restraint when investing in pooled funds where the commitment to the market is immediate.



Source: Datastream/IPD

Markets' sweet spot

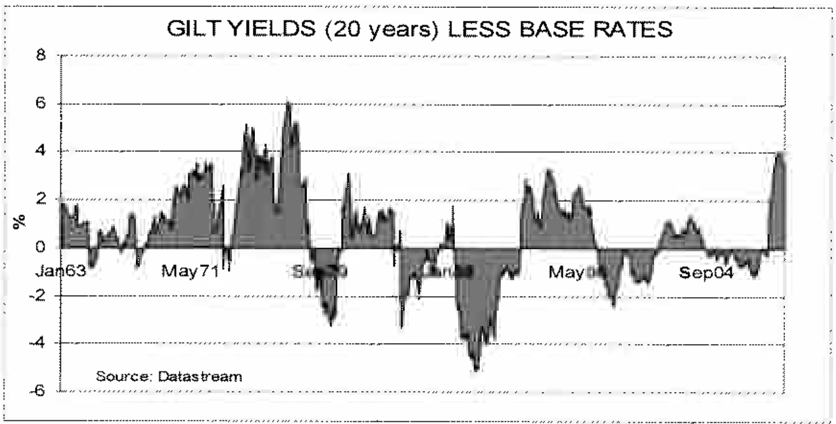
With hindsight, it is now apparent that the onset of "quantitative easing" in the spring in the major economies provided a powerful jolt to markets. Bank lending has not increased, but liquidity in banking systems has been greatly boosted, helping markets. The continuation of the market rebound during the third quarter was broad-based, encompassing equities, government bonds, corporate bonds and property. The simultaneous rally in government bonds and equities was particularly striking, suggesting a market sweet spot – confidence in the economic recovery together with sufficient reassurance from central banks that current extraordinarily low interest rates and bond purchase programmes would be maintained.

Benign environment unlikely to last

Our view, however, is that this benign market environment for all asset classes is likely to be transitory. Beyond the US fiscal boost which is now fading and the inventory bounce in GDP in many economies (companies no longer running their stocks down counts as positive economic growth), economic prospects are still cloudy. We believe there is limited fuel for a consumer or business spending recovery in the major economies. If, on the other hand, the recovery is more vigorous than we expect, there will be a more prompt withdrawal of fiscal and monetary stimulus than markets currently expect. Either way, the benign environment would end.

Gilts are expensive

Fixed income gilt yields, in common with global government bond markets, have attracted increased support of late. Reassuring talk from central banks about the likely period of low interest rates and continuation of gilt and other asset purchase programmes have helped. Doubts about economic growth in 2010 have also become more evident. Though gilt yields are at very low levels, relative to the current level of short-term interest rates, yields do not appear low at all (see chart).



The downward pull on yields of very low short-term rates should not obscure the fact that gilts are unusually expensive. Both fixed gilt yields and index-linked gilts are highly unattractive relative to the levels we would consider reasonable, the latter showing the lowest yields since issuance began in the 1980s. However, the *difference* between yields on fixed income gilts and index-linked gilts of similar maturity (referred to as the 'break-even inflation rate') looks reasonable against our expectations of inflation. This suggests that inflation protection component of gilts can be purchased on reasonable terms.

Consider switching fixed gilts to index-linked

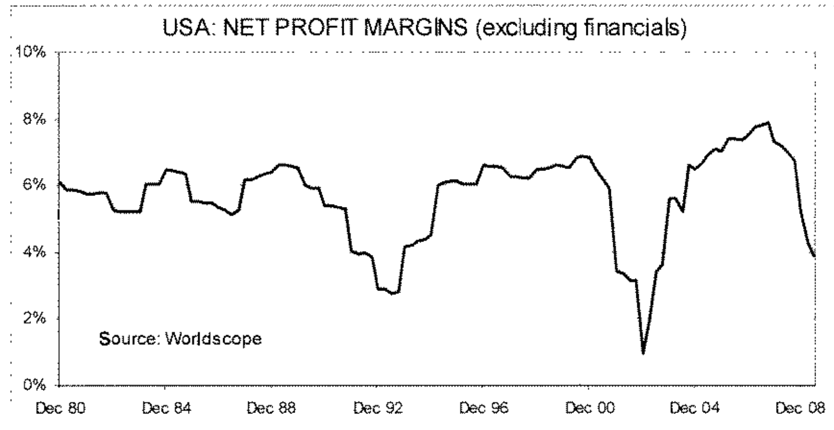
Taking this and our view that there is a risk of much higher inflation over the long-term, it seems sensible to consider switching allocations from fixed interest gilts towards index-linked. Where liabilities are more inflation-linked and portfolios are underweight inflation protection, the argument strengthens. Duration should also be considered, however, as the generally longer duration of index-linked relative to fixed income gilts could imply a stronger price impact if yields faced upward pressure.

Credit - now more a 'relative' than an 'absolute' case

Corporate bonds have rallied hard, delivering equity-like returns during the quarter as spreads against gilts came down sharply alongside falling gilt yields. The average yield on corporate bonds (Merrill Lynch non-gilt index) fell by 1.2% in the third quarter alone. It is clear that the rapidity of spread tightening has been driven by the same revival in risk appetites that has delivered such strong equity market gains. The onset of a less benign market environment could therefore see a setback. However, our view is that the impact of this is unlikely to be particularly marked. Spreads are still high enough to be discounting fairly bad newsflow on credit quality. This means that the relative case against gilts is still good. In absolute terms, however, expected returns from corporate bonds now look less appealing than a few months ago.

Profit margins fall, but less than expected

As we have highlighted before, profit margins in major equity markets were at record highs in 2007, before the onset of a harsher economic environment. Profit margins have been squeezed substantially as a result (see chart on US trends).



Underlying profitability trends are better captured by focusing on the non-financial sectors. This avoids the distortion of large falls resulting from the lurch to big losses in the financial sector. US profit margins have fallen substantially from their peak on this basis. Though margin contraction (on an ex-financials basis) this time has not reached the pace of the post dotcom bubble downturn of 2001-2, the severity of the fall in the previous period mainly reflected the special problems of write-downs in the telecom and technology sectors.

A better comparison is with the 1991-2 recession. We find that net profit margins outside the financial sector have broadly halved in this downturn, compared with a decline of 60% in the early 1990s recession. Considering that both the USA and the rest of the world have endured a much deeper economic downturn than the early 1990s, this counts as a good performance. Unlike the early 1990s, sales have fallen, but deep cost cutting has protected margins to some degree.

Equities risk disappointment

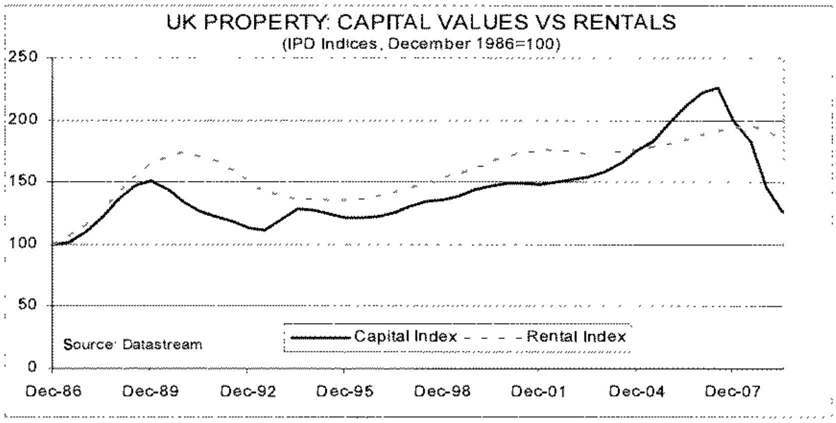
With profitability having held up better than expected, our view is that expectations are now at risk of running ahead of what is achievable in the year ahead. Current consensus earnings forecasts (US earnings growth expectations range from 20-35% in calendar 2010) imply a substantial recovery, taking profitability back most of the way to its earlier peak by 2011. Such a vigorous recovery in earnings and profit margins did happen in the early 1990s. This time, with a backdrop of a likely weak economic rebound, such a recovery appears much less likely. Alongside the risk of earnings disappointments, we also note other unsupportive factors for equity markets such as booming share issuance and strong selling by directors of companies. Taken together, these indicate to us that equities face a struggle to make further headway. We would not advise adding to equity positions now. Indeed, we regard it as a good time for some funds to trim overweight positions back.

Sterling hedging conditions improve

Sterling has weakened again, more noticeably against the euro and the yen than the US dollar. Sterling's renewed downward lurch has improved conditions for implementing new hedges where portfolios are below their normal hedging exposure. We are not aware of the Committee's views on currency hedging, and so now may be an opportune moment to discuss this area further.

Keep some ammunition back in property

Property valuations are attractive. Capital values had more or less halved (the official indices understating the falls slightly) taking yields to over 8%. These yields look attractive even after allowing for further falls in rents to come (see chart).



Though valuations are attractive, some care needs to be taken in raising property allocations. Supply shortages are in danger of boosting transaction prices too quickly. Also, property has benefited from the strong rally in risk assets which we can see being reversed for a period of time. Therefore we are happy to invest with property managers at present that will take some time to invest the funds but would advise some caution if investing in pooled vehicles where the commitment to the property market would be immediate.

Hedge funds preferred to other alternatives

For alternative classes, our preference remains for hedge funds, with an emphasis on strategies that are not market directional. At the other end of the spectrum, our least favoured asset class is still private equity. We believe that returns in private equity (in the dominant buy-out sector) will be undermined by curtailed and costlier leveraged finance and high debt burdens in the companies which have been taken into private ownership.

Commodities are unattractive at this time

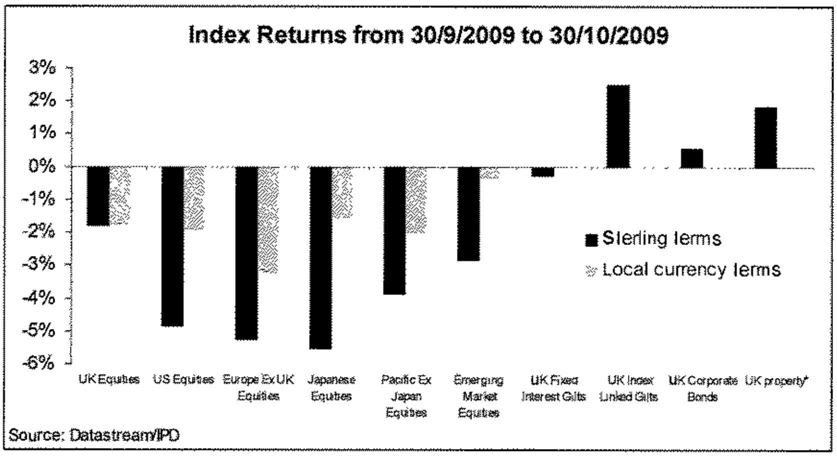
At this time we remain negative on commodities as an asset class for a number of reasons:

- 'Risky'/economically cyclical investments have performed exceptionally strongly since the lows this year, to a considerable extent because of the enormous liquidity poured into the system by central banks and because of the improved economic environment. The timing of the withdrawal of this liquidity by central banks has now become a negative factor affecting markets while, in our view, the economic recovery will be less robust than many envisage. In short, we believe that 'Risky'/economically cyclical investments such as commodities have moved too far, too fast.

- Our arguments for a rather subdued economic recovery include the very low levels of capacity utilisation and continued de-leveraging required in the western world which will restrain final demand. These features should have a subduing impact on commodity prices, even if China continues to steam ahead. Another negative factor for commodities is the high level of inventories which appears to have been built up in China.

- Many of the major commodity prices are trading well above their marginal costs of production so 'valuations' are not supportive. Roll returns are also a negative factor for commodity returns.

October Market Update

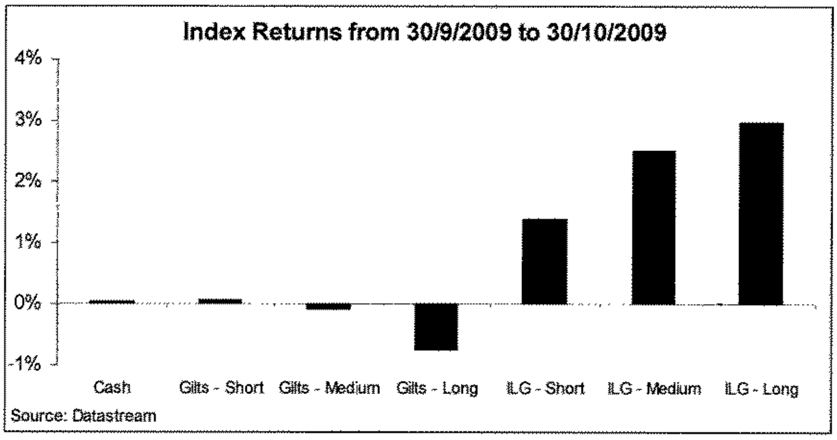


Index Returns from 30/9/2009 to 30/10/2009

Source: Datastream/IPD

* Property relates to end of August 2009 to end of September 2009

- In October the broad equity market rally showed signs of fatigue, every major market ended the month lower. In local currency terms, Emerging Markets performed best and European ex UK equities performed worst.
- Sterling strengthened in October dragging down the performance of overseas markets in sterling terms. In sterling terms the best performing market was the UK and the worst was Japan.



Index Returns from 30/9/2009 to 30/10/2009

Source: Datastream

- Short and medium dated fixed interest gilts were flat over the month outperforming longer dated gilts where performance was negative. Index-linked prices rose across all maturities; long dated gilts returned the most and short dated gilts the least.
- Corporate bonds returned 0.6% continuing their run of positive returns which began in April 2009. Credit spreads have continued to fall and yields remained fairly flat over the month.
- Property returned 1.8% over October, the third successive month it has generated a positive performance.