

Asset Allocation Report – February 2010 London Borough of Haringey



22 February 2010

Prepared for
Pensions Committee

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Contents

Executive Summary	1
Quarterly Investment Outlook	3
The Case For Property	7
January Market Update	12
Disclaimer	13

Executive Summary

Investment Outlook

- The benign environment that has strongly boosted asset prices is ending. A reversal of easy monetary conditions is about to begin.
- High budget deficits, the end of Bank of England bond purchases and cyclical factors will push gilt yields higher, even as short-term interest rates stay low.
- Equities are losing support, impacted by the changed monetary environment, higher bond yields and a challenging profits outlook.
- Despite a recently strong showing by property, we still like this asset class, together with hedge funds within the "alternatives" area.

Asset Allocation and Fund Benchmark

The Fund's asset allocation and benchmark weightings at 26 January 2009 are shown in the table below:

	Value £m	Total %	Bmark %	Suggested Range
UK Equities	169.5	27.2	30.5	25 - 35
Overseas Equities	216.2	34.7	34.5	30 - 40
UK Gilts	28.7	4.6	7.0	0 - 10
Index Linked Gilts	39.4	6.3	6.0	0 - 20
Corporate Bonds	77.4	12.4	7.0	0 - 15
Private Equity	12.3	2.0	5.0	2 - 5
Property	41.8	6.7	10.0	5 - 15
Cash (in custody accounts)	3.6	0.6	-	0 - 10
Cash (internal)	34.3	5.5	-	-
Total	623.2	100.0	100.0	-

Source: Northern Trust and Haringey

What this means for the Fund

- **Equities** – equities have had a good run but we believe they will struggle from here. We are comfortable with the 3.1% underweight position overall.
- **Bonds** – Corporate bonds have done very well over the last six months, and gilts are still looking expensive. Our advice is to reduce gilts by 2.0%, index-linked gilts by 0.3% and corporates by 2.4%, holding this in cash for the moment. **Given the time sensitive nature of this advice at the date of the report, we recommend it is implemented immediately.** We recommend that the cash raised is made available to be invested in property up to the benchmark weighting. We are comfortable with holding a relatively high proportion in cash pending the outcome of the upcoming investment strategy review.
- **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.
- **Private Equity** – we do not believe that the Fund's private equity allocation should be increased at this time.

Success of implemented advice so far

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 one 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 benchmark to which they manage assets.

As a result, approximately £10 million was transferred from UK gilts to corporate bonds in early August.

The returns for the six month period from August - January, are as follows:

Six months to 31 January 2010

	Fund	Benchmark
UK Gilt Fund	5.1%	2.5%
UK Corporate Bond Fund	11.8%	9.1%

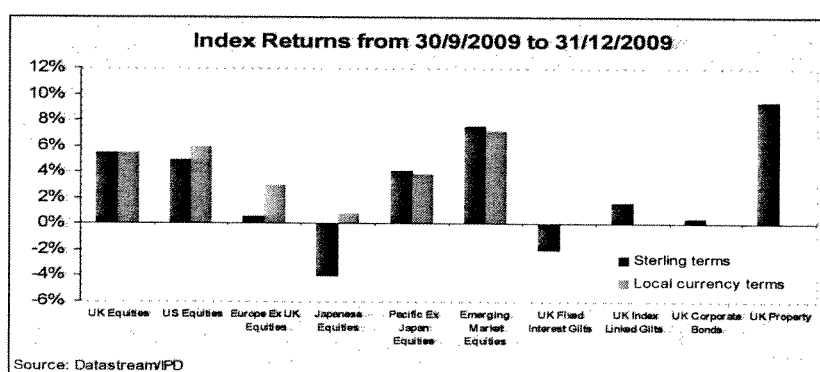
Source: Fidelity

Using the benchmark returns shown above, the move from gilts to corporate bonds generated an additional return of approximately £660,000 over the six month period. Clearly this has been a beneficial asset allocation move for the Fund.

Quarterly Investment Outlook

Summary

- The benign environment that has strongly boosted asset prices is ending. A reversal of easy monetary conditions is about to begin.
- High budget deficits, the end of Bank of England bond purchases and cyclical factors will push gilt yields higher, even as short-term interest rates stay low.
- Equities are losing support, impacted by the changed monetary environment, higher bond yields and a challenging profits outlook.
- Despite a recently strong showing by property, we still like this asset class, together with hedge funds within the "alternatives" area. Commodity returns are likely to disappoint.



Benign market environment to be challenged

Equities and other "risky" assets have benefited from an economic rebound. Coming from very low levels of activity, there has been little immediate worry over inflation or an early end to stimulatory economic policy. However, such a benign environment is now under challenge on two fronts. First, the economic turnaround so far has relied on strong budgetary and monetary stimulus everywhere, from China to the USA. As this is withdrawn, the ability of private spending (consumers and companies) to step up and fully compensate is doubtful. Second, even though spare capacity resulting from the recession should keep inflation low for some time, concern over inflation has risen. This is evident from higher long term inflation forecasts in consensus surveys, a growing gap in yields between fixed interest and inflation-linked bonds, and firm commodity prices. This leaves central banks with the difficult challenge of doing enough to maintain credibility over inflation, while still ensuring that economic activity is not hindered by any premature monetary tightening.

The phases of monetary tightening

We expect the process and mechanics of monetary tightening to occur in four phases as follows:

Phase 1: Quantitative easing will end. This has already begun in the USA and the UK where it has been an important part of policy. Bank of England gilt purchases will soon be complete. In the USA, various emergency lending facilities are being withdrawn, offsetting asset purchases.

Phase 2: The second phase is the active roll back of the extra money put into the system – draining the large commercial banks' reserve balances that are the counterpart of the central bank asset purchases. Though idle now, these reserves are large and there is a need to drain some of this away this year to forestall inflationary pressures later. Central banks will do this using a variety of money market management tools available.

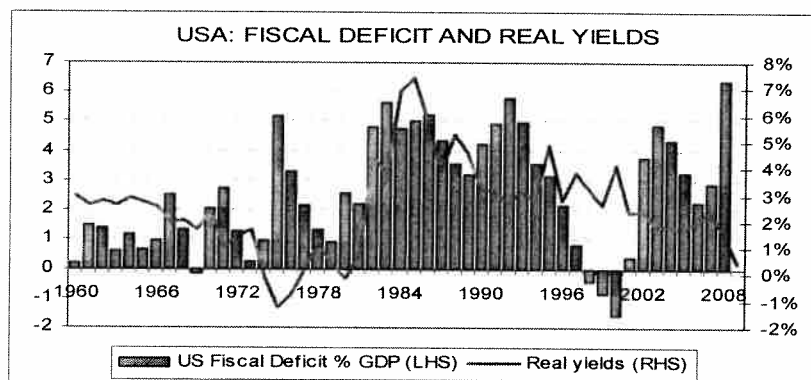
Phase 3: The third phase is raising short-term policy interest rates. Currently, consensus sees UK base rates rising in the second half of this year, approaching 3% by the end of 2011.

Phase 4: This phase sees central banks return to more normal balance sheets, involving the sale of bonds purchased under quantitative easing. It is unlikely to feature soon, as it could create major problems for bond markets struggling with large issuance. In fact, it could be several years before central bank balance sheets are fully unwound.

Though all of this will take time to be completed, we expect investors to anticipate the effects of these changes and markets to be on the defensive as the reversal of the easy monetary stance takes effect.

Bond yields to move higher

For some years, global bond markets and gilts in particular have been expensive on our valuation metrics. This can be attributed initially to the desire of Asian and Middle Eastern central banks to recycle their trade surpluses into the US Treasury bond market with knock-on effects elsewhere. The credit crisis and consequent desire for 'safe haven' assets then continued the downward pressure on yields. Recently, quantitative easing has been a dominant influence on gilt yields with huge issuance of gilts in 2009/2010 more or less offset by Bank of England gilt purchases.



We believe this period of expensive bond markets is now at an end. As shown in the chart above, real bond yields (adjusting nominal bond yields for inflation) should broadly track budget deficits and the discrepancy in the trends at present is all too obvious. As quantitative easing ends, real yields should increase on a sustained or secular basis. More cyclically, increasing capacity utilisation in the industrial sector and a bottoming out in unemployment rates should lead to a rise in real yields, if history is any guide. However, short term interest rates close to zero have made the US yield curve as steep as at any time since 1992, restraining the upward move in long term yields for the time being. The bottom line is that we believe that fixed income gilt yields have further to rise and preferably we would not make purchases until longer dated UK yields reach 5%.

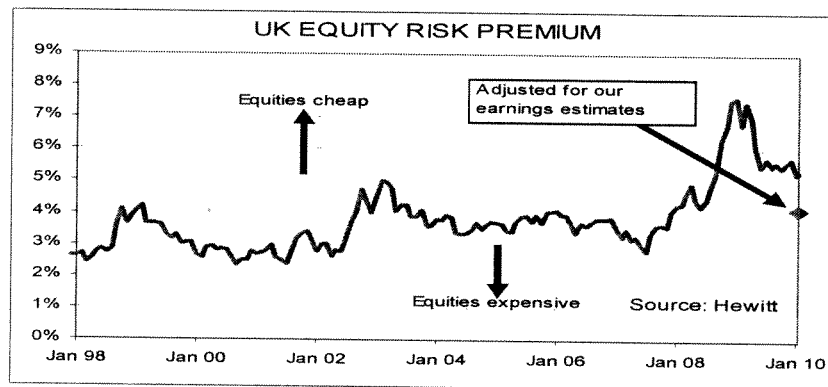
Similar story for index-linked yields

The same factors apply to index-linked gilts where yields are also clearly below our long term 'fair value' estimates so here too we would wait before committing cash to index-linked gilt purchases. We believe 'break-even' inflation rates (the difference between fixed interest and index-linked gilt yields of the same maturity) should be around 3.5% at present. This comprises a long-term inflation expectation of 3% and an inflation risk premium (the amount investors are prepared to pay for insurance against inflation risk) which has historically been around 0.5%. Current break-evens still offer opportunities to switch from fixed income to index-linked gilts to terms of 15 years or so, where liabilities are inflation-linked.

Corporate bonds still attractive versus fixed interest gilts

Greater confidence in the economic outlook has caused the earlier undervaluation of corporate bonds to reduce. Gilt yields are also set to rise. Nevertheless, we still see corporate bonds as attractive relative to gilts, although we have turned to a more neutral stance against cash.

Equities likely to lose support



The equity rally since last March has gone well beyond our expectations, with the move in the S&P 500 having entered the record books as the largest upward move within a year in the past century. However, equities now face formidable obstacles in taking the rally forward. Higher financial system liquidity from quantitative easing clearly helped asset prices, but this monetary stimulus is now ending, with a reversal to follow. This pull-back of easy monetary conditions is likely to exert some pressure.

Additionally, rising bond yields will dent the valuation attractiveness of equities. In calculating the equity risk premium (the additional return equity investors require over gilts) we already allow for the likely shortfall of corporate profits relative to consensus expectations (see chart), but higher bond yields would take the premium into outright unattractive territory. Other measures of valuation show equity markets now are close to long term averages: forward looking price to earnings ratios are only marginally lower than average and the current UK price to book value ratio of 2x is slightly higher than the average since the 1970s. Our assessment is that valuation support for a continuation of the equity rally is now thin.

Equities: a sellers' market

Most of the factors which drive equity markets forward are likely to offer limited support from here on. The changed monetary environment, with the four stages of tightening discussed earlier, is an important source of discomfort. Corporate profits are rebounding, but the increase over 2010-11 as a whole will be weaker than the market currently expects. Weighing up these factors, we believe this is a sellers' equity market rather than one for buyers and we stay on the sidelines.

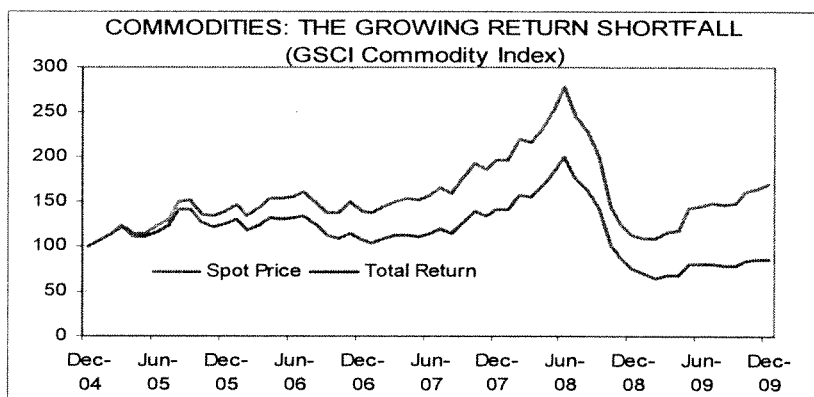
Within equities, we prefer lower risk large capitalisation stocks in developed markets. Higher 'beta' areas of small cap and emerging markets have been strong, unsurprisingly, given the strength of equity markets in general, but a mood of greater caution among investors could easily lead to a disorderly reversal. Our regional focus has favoured Japanese equities and this remains.

Hedge funds and property preferred within alternatives

Ongoing market volatility and greater than usual valuation anomalies suggest attractive opportunities for hedge funds. We believe attractive risk-adjusted returns are available without the need for high leverage or rising equity markets. A stressed economic and financial environment should mean that global macro and distressed debt strategies will have scope to deliver strong returns.

Almost alone among 'directional' asset classes (those which depend on a rising market), property remains undervalued and attractive in our opinion. However even here, we would exercise some caution in making purchases. Very strong demand for desirable properties at this time is pushing up prices too sharply, and a relapse in investor optimism could see prices fall back somewhat. The next section of this report provides a more in-depth look at the property market.

Commodities: disappointments likely



For several years, spot commodity prices have been a poor guide to returns achieved. Prices have risen by 70% (on the widely-used GSCI index) but returns are negative (-15%) over the last five years. Negative roll returns (selling shorter dated futures contracts to buy longer dated contracts) across a range of commodities, particularly energy, are to blame. Given prices are above marginal cost in energy and metals at this time and slowing Chinese demand, the outlook for commodity prices is not strong. Unless roll returns reverse very substantially, which we consider unlikely, medium term commodity returns will disappoint.

The Case for Property

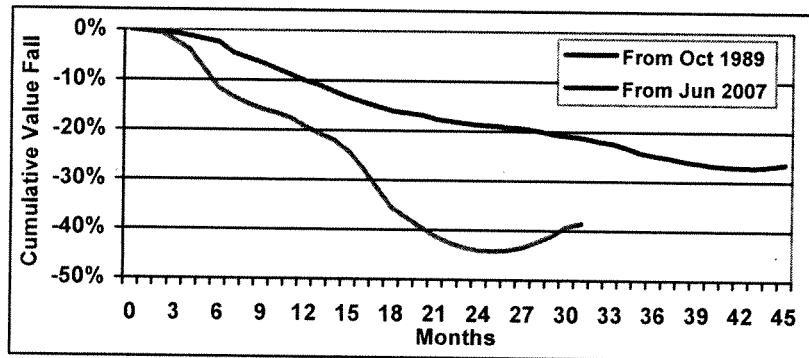
UK property market

The UK property market experienced a dramatic fall in prices since the peak of the market in June 2007, with capital values falling over 44% over 24 months to mid 2009.

Although there has been a rally in property yields for good quality stock over the second half of 2009, capital values still remain 36% below their peak (based on the Investment Property Databank Monthly Index as at end-January 2010).

The re-pricing of property yields which started in mid-2007 was initially driven by a deterioration of investor sentiment (driven by low yields), joined later by a decline in rents achievable on new lettings and lease renewals, as tenant demand weakened.

Both the rate and extent of this decline is unprecedented - it has been twice as fast and almost twice as deep as the 1990s property crash as shown by the chart below.



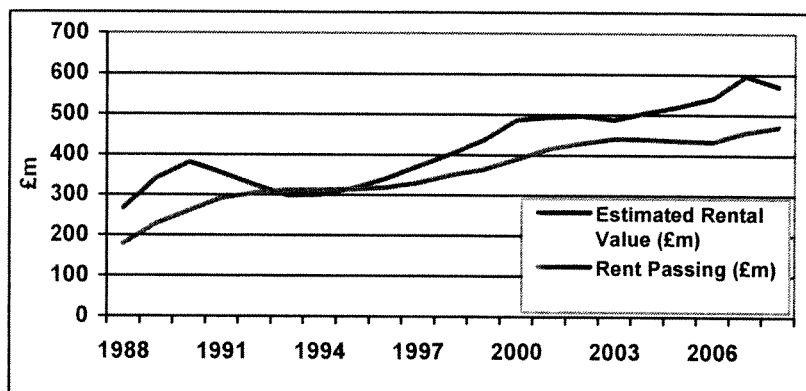
Source: IPD Monthly Index

Unlike the 1990s property crash, this downturn has not been preceded by a property development boom. For example, over three times as much floor space was delivered to the City of London office market in 1989-1992 as is due for delivery over the period 2008-11. Furthermore, the proportion of property sitting vacant has not increased to the same levels as the early 1990s.

Commercial property rental values continue to decrease with the IPD Monthly Index having already recorded a 10% fall since rental values peaked in Q2 2008. While there are certainly further rental value declines to come, the structure of UK commercial property leases provides some insulation from these declines feeding into investors' income streams. This is principally due to:

- Upward only rent reviews – these remain common market practice and essentially prevent the rent payable falling back to market levels until the lease expires.
- Long leases – the average length of the new leases granted in 2007/08 was 11.7 years to expiry or the first break option for the tenant to terminate.

The impact of lease structures can be seen in IPD Annual Index data during the last two periods of rental value decline in the early 1990s and 2002-03 in the chart below. Over both periods, rental income to investors remained stable instead of falling.



Source: IPD Annual Index held sample

We currently have a preference for UK property as opposed to overseas exposure. The primary reasons for this are as follows:

- The UK property market is substantial and has a high level of transparency. It has been attractive to both UK and foreign investors on a long term basis.
- In our experience, manager fees and fund running costs are materially higher overseas.
- It is not possible to gain access to overseas property without investing in funds that use gearing which can result in increased performance volatility.
- Whilst commercial property markets outside the UK have also experienced price declines, for the most part, the UK is further advanced in its price correction cycle.
- The characteristics of some overseas property markets have greater similarities to index linked bonds due to the market structure.

Even with the scale of the fall in UK property prices there are still questions to ask:

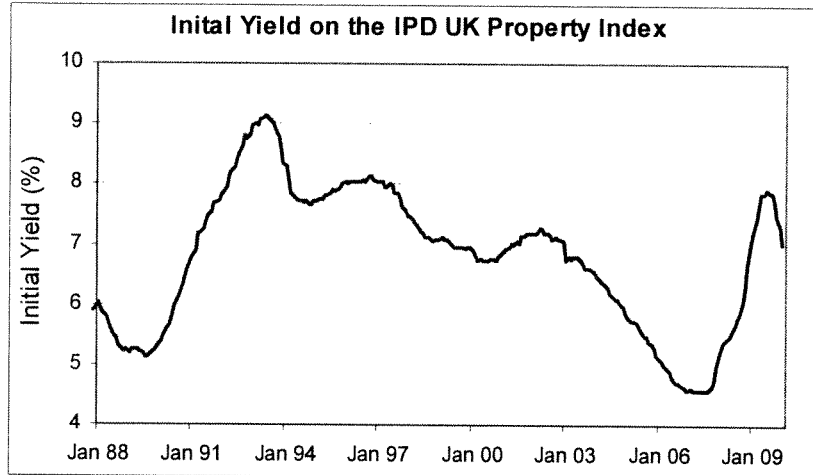
- Are UK property valuations attractive? If so,
- Is there a strong strategic case for investment in UK property? and
- Is the timing right to increase allocations to UK property?

Are property valuations attractive?

The rate of decline in UK commercial property values slowed towards the end of Q2 2009 with valuation yields stabilising and then declining over the second half of 2009. The IPD Monthly Index initial yield is now 7.0% compared to a long run average of 6.4% from IPD Indices back to the early 1970s.

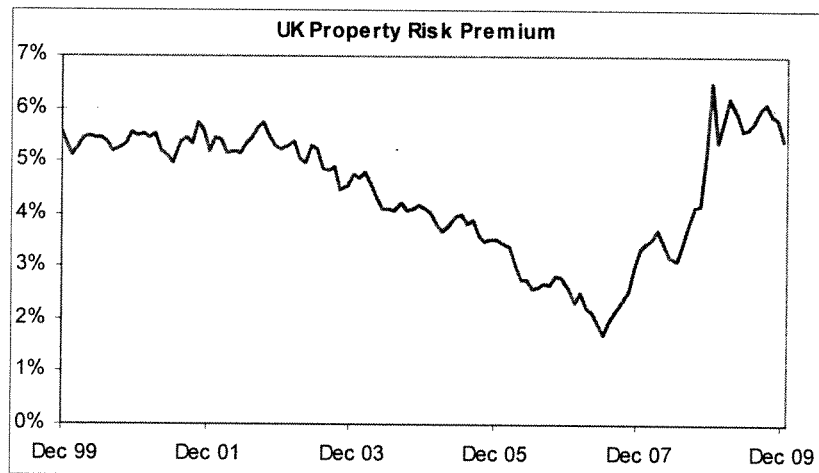
For the best quality "prime" properties, evidence from transactions over the second half of 2009 demonstrate that yields have improved significantly, with capital values rising as a consequence. However, properties where tenant quality, lease length, building or location quality are somewhat impaired are unlikely to benefit from material yield compression in the short-term, although investors are now showing increased interest in these assets too.

Using initial yields as a valuation measure, UK property appears to be the most attractively valued it has been for around ten years.



Source: IPD

However, our preferred property valuation measure is the Property Risk Premium ("PRP"), which is the additional return that investors expect over gilts. It reflects the additional risk investors perceive investing in property, such as the potential for rents to fall and increases in void levels if tenants fail or do not renew tenancies.



Source: Hewitt Associates Limited

The chart shows that investors currently expect property to return just below 6% p.a. more than index-linked gilts (compared to the long term average of 4% p.a.) The message is that property appears to be attractively priced relative to gilts.

The strategic case for investment in property

UK property valuations are clearly looking more attractive now but we should also compare the outlook for property against other asset classes.

In the table below, we set out our in-house long-term assumptions for the expected returns and risks of various asset classes as at 31 December 2009.

Our expected return for new property investment as at 31 December 2009 was 8.4% p.a. Our calculations incorporate rental values falling by around 10% over the short to medium term due to depressed property demand. Thereafter, rental income is taken to increase in line with inflation, assumed to be 2.4% p.a.

**How does UK property compare to other asset classes?
Hewitt Assumptions at 31 December 2009**

	UK Property	UK Equity	Fixed Interest Gilts	ILG	Corporate Bonds
Expected return (%)	8.4	8.0	4.3	3.3	5.4
Volatility of return (%)	18	25	11	9	12
Correlation with Property	1.0	0.2	0.1	0.1	0.1

From the table above it can be seen that we expect property returns to be greater than those for (passively managed) UK equities but with much less volatility. We also expect property to comfortably outperform corporate bonds.

Combined with other assets, we believe that property provides a good diversification of returns with low correlations to equities, corporate bonds and index-linked gilts. From a liability perspective, property can also provide a partial hedge against rises in inflation over the long term.

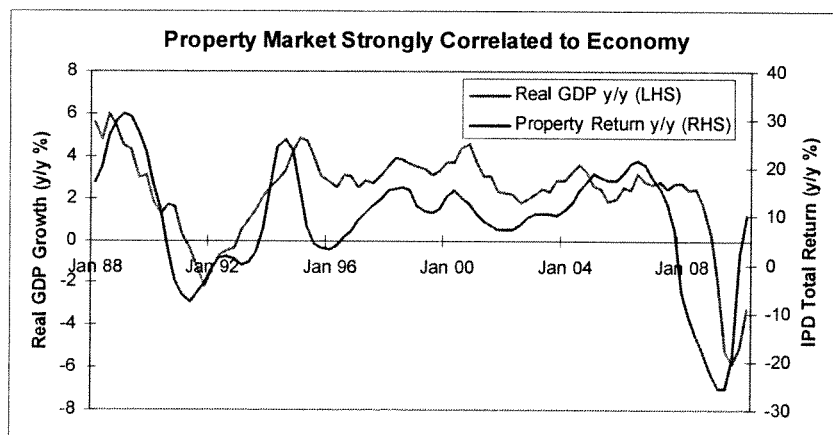
On the downside, property can be very illiquid with high transaction costs (around 7% for the combination of buying and selling a property) and physical property management costs are much higher than the management costs for equities or bonds although this is reflected in the figures above.

Timing

But is it the timing right to invest? In this section, we consider some factors which help to judge an appropriate time to invest in property.

Economic Growth

Property returns are cyclical and tend to follow the business cycle as shown in the chart below. Property prices tend to rise when GDP is growing. This is intuitive as an expanding economy creates employment, increasing demand for office space and industrial units, and greater wealth tends to be spent in shops, increasing the demand for retail space.



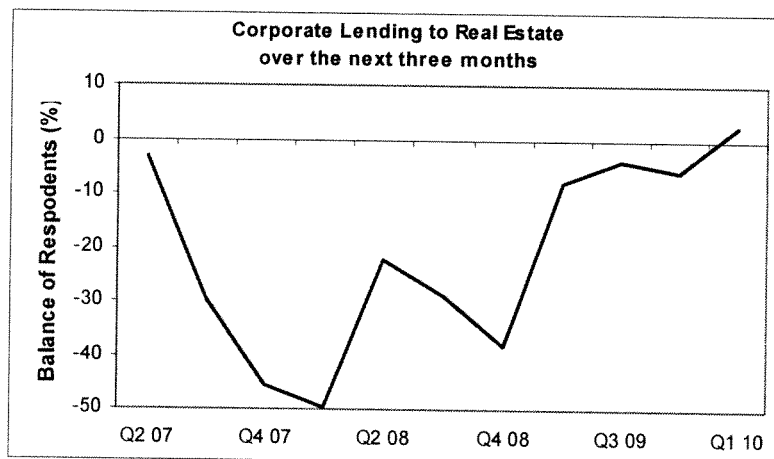
Source: Thomson Datastream

With the economy expected to bottom over 2009/10, even if we see an anaemic recovery, investment in property may prove timely - particularly with the strong yield underpin available.

Credit

The cost of credit, and hence credit spreads, and interest rates influence the return on property investment. This is because they determine the cost of financing property investment for a large number of investors. Five year UK swap rates are often used as a proxy for financing costs and currently stand at circa 3.1%. At this level, even after allowing for still significant bank lending margins, property has again become self-financing.

The property market is also affected by the ease of obtaining new credit, as well as by the cost of credit. We use the Bank of England's Credit Conditions Survey as an indicator of credit availability (a positive balance indicating that more credit is available) and this is shown below.



Source: Bank of England

The enormous support offered by the Government to banks has now helped to slow the contraction in credit availability, although banks are still fairly reluctant to lend. Nevertheless the trend is upwards, albeit the process may well be slow as banks rebuild their balance sheets.

Commercial property loan books

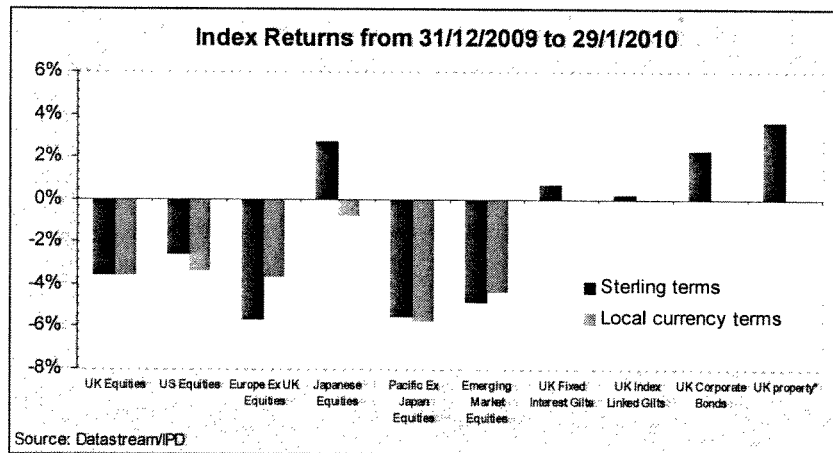
The strategy of the UK and Irish banks at the moment is to 'extend and amend' in terms of their commercial property loans book. In the vast majority of cases, the banks do not want the assets back on their balance sheets and are seeking to extend expiring loans or amend terms in other ways. Banks will of course take tougher action where there has been a breakdown in the lender-borrower relationship, property income is failing to cover interest costs, or where the bank has lost faith in the borrower as an asset manager.

The banks may of course release more stock over time. However, banks are much more focused on bringing in new advisors/asset managers to work out the assets over the medium term rather than flood the market with distressed sales.

Conclusion

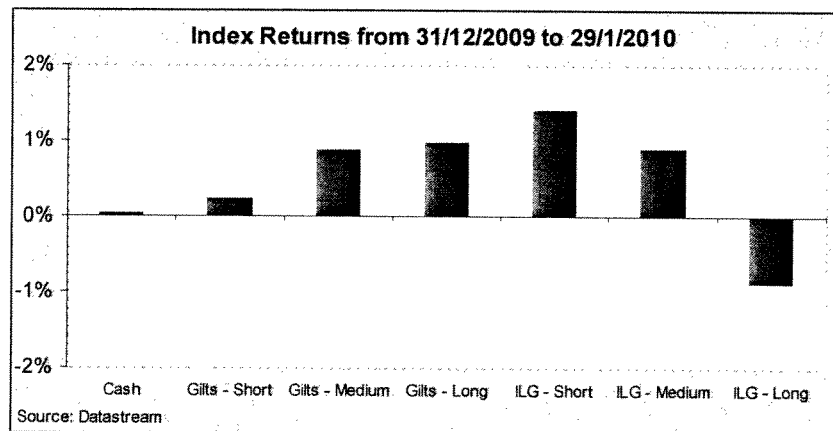
The strategic case for property investment remains strong and, almost alone among 'directional' asset classes, property remains undervalued and attractive in our opinion. Some selectivity is needed however as there is a risk that strong demand for desirable properties at this time is pushing up prices too sharply, and a relapse in investor optimism could see prices fall back somewhat.

January Market Update



* Property relates to the month of December 2009

- Equity markets fell over the first month of the year with Pacific ex Japan equities (-5.8%) registering the worst performance in local currency terms. Japanese equities returned +2.7% over the month as sterling weakened against the yen.
- Over January, sterling strengthened against the euro (2.4%), even though it weakened against the yen (-3.4%) and broadly held level against the dollar (-0.8%).



- Fixed gilt yields fell across all maturities in January, with long dated gilts outperforming short and medium dated gilts. Real yields on short and medium dated index-linked gilts fell over the month but rose on longer dated index-linked gilts.
- Corporate bond returns were positive in January as fixed interest yields fell and spreads tightened a little further.
- Property returned 3.6% over December, the sixth successive month of positive performance.

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