Pensions Investment Committee			
Report Title	**Investment Performance for Quarter Ended 30th September 2010**		
Key Decision	**No**		**Item No. 5**
Ward			
Contributors	**Executive Director for Resources**		
Class	**Part One**	Date: **18th November 2010**	

1. SUMMARY

1.1 This report sets out the performance of the pension fund investment portfolio and that of the individual managers for the quarter ending 30th September 2010 and a commentary on the prospects for investment markets.

1.2 The report comprises the following sections:

2. Recommendations
3. Background
4. Portfolio Summary
5. Conclusions
6. Financial Implications
7. Legal Implications
8. Appendix 1: Independent Investment Advisors Report.

2. RECOMMENDATIONS

Committee is recommended to note the contents of the report.

3. BACKGROUND

3.1 The revised management arrangements for the Pension Fund investment portfolio have been operational for approximately two years and this report sets out the performance for the quarter ended 30th September 2010 and since inception as provided by the Fund's investment advisors Hymans Robertson.

3.2 The economic context within which managers can perform is provided by the Investment Report as set out in Appendix 1 of the report.

3.3 The full report and performance commentary will be provided at the meeting by the investment advisors.

4. PORTFOLIO SUMMARY

4.1 The fund had a market value of £703.7 million at the 30th September 2010 which represented a gain of £46. million (7%) over the June valuation of £657.7 million.

4.2 The fund achieved a return of 6.8% in the quarter which was 0.8% below the benchmark of 7.6%. The fund performance over the longer term is a set out below.

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4.3 The Council participates in a performance measurement survey conducted by the WM Company. This ranks the Council's investment against that of the other 97 Councils participating in the survey and expresses this as a position out of 100. In the latest figures available up to the quarter ending the 30th June 2010 the Council ranked 71st with the principal detractor from performance being overseas equities where the Fund ranked 93rd.

4.4 The fund currently employs nine specialist managers with mandates corresponding to the principal asset classes. The managers and the associated performance targets are as set out below.

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4.5 The performance of the individual managers relative to the appropriate benchmarks is as set out in table 3

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The table indicates the relatively short duration of the current structure and that all managers with the exception of the Bond manager have underperformed their respective benchmarks in all periods.

4.6 The performance of individual managers against their respective targets is as set out below:

Alliance Bernstein	-0.1%	Stock selection and exposure to commodity and financial stocks was positive but was offset by negative currency selection and fees.
Fauchier	-0.3%	Short term positions detracted from performance.
Harbourvest	-7.0%	Limited activity in market impacted on valuations.
RCM	-1.7%	Under performance attributable to exposure to industrials and financials which was only partially offset by positive investments in the information technology and materials sectors.
Schroders	-0.2%	Continental Europe exposure and cash holdings detracted from performance. Recent recovery in Europe and reduction of cash balances should enhance performance going forward.

UBS (Equity)	-0.1%	Index tracker fund with only minimal tracking error
UBS (Bonds)	+0.6%	Out performance attributable to overweight position in financials and underweight in sterling.
Investec	-5.5%	Short positions taken in a number of commodities detracted from performance because commodities rose in the quarter.
M&G	+.01%	Limited demand in market for credit reduced investment opportunities.

5. CONCLUSION

5.1 Performance continues to be below benchmark with limited progress being made to turn round performance

6. FINANCIAL IMPLICATIONS

6.1 The comments of the Executive Director for Resources have been incorporated into the report.

7. LEGAL IMPLICATIONS

7.1 As the administering authority for the Fund, the Council must review the performance of the Fund's investments at regular intervals and review the investments made by Fund Managers quarterly.

7.2 The Pension Regulations require that the Council has regard to the proper advice of its expert independent advisers in relation to decisions affecting the Pension Fund. They must also have regard to the separate advice of the Chief Finance Officer who has statutory responsibility to ensure the proper administration of the Council's financial affairs including the administration of the Pension Fund.

Appendix 1: Investment Report: Q3, 2010

Market Summary

The third quarter of 2010 produced a robust recovery from all assets (Figure 1) from the falls of Q2 caused by the severe fiscal crisis in Europe. A focus on cyclical rather than systemic issues was sufficient to encourage a revival of spirits, which occurred despite suggestions of a faltering recovery in the US. The move higher was, however, from a straight line as the 'Market Postcards' later in this note illustrate with the principal punctuation coming from the nuances of prospective policy moves emanating from the US Federal Reserve. Over the piece, the likelihood that a second, probably substantial, wave of quantitative easing (QE) will be announced in November was sufficient to lift asset prices; after all, the 'funny money' has to go somewhere.

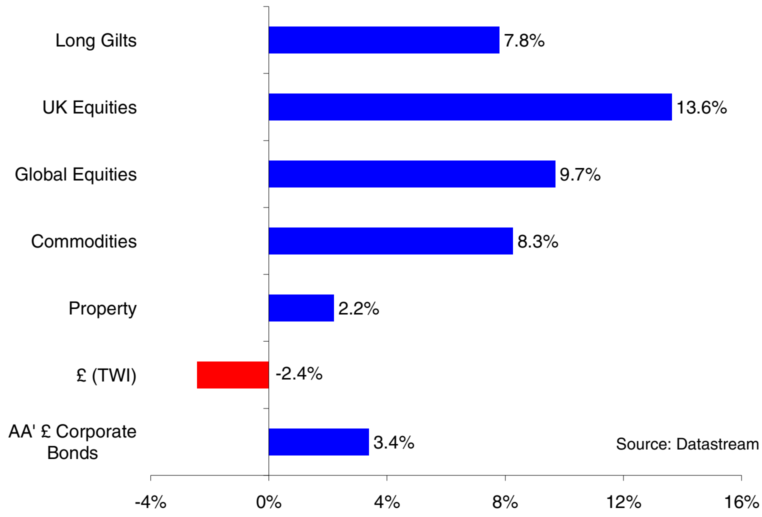


Figure 1: Market Performance – Q3, 2010 (total return)

Suggestions of QE2 also weighed heavily on the $ and, with many investors expecting the UK to echo any such action from the US, Sterling also fell. Despite all its ills but supported by a mini economic boom in Germany, the € enjoyed good gains in Q3.

Events have ensured that the money markets in the major economies, have continued to purge any thoughts of an increase in official short-term interest rates (Figure 2); 'low for a long, long time' is becoming embedded in investor psyche and is exerting a profound influence on asset markets – see Commentary.

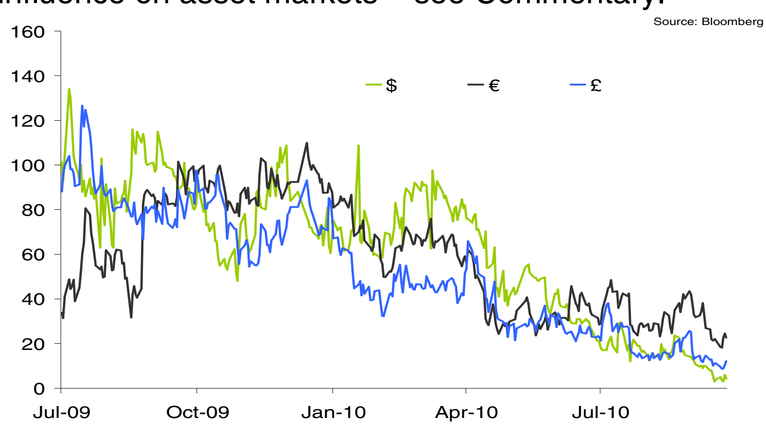


Figure 2: Expected Change in Official Rates – 1 year hence

Market Observations

We remain in an economic and market environment for which there is scarce precedent in living memory. The journey back to normality remains extremely challenging. Yet some established metrics continue to suggest standard cyclical behaviour.

Figure 3 plots the difference in US and German 10 year yields; the natural 'rhythm' of the past twenty years appears in place. In all likelihood then, US yields will continue to fall relative to their European equivalent, which, if bund yields remain unchanged, could see US yields trough at 1% below current levels i.e. at 1.6%. If core US inflation remains at current levels this would imply an average nominal growth rate in the US economy of less than 3%; small wonder the Federal Reserve is getting twitchy!

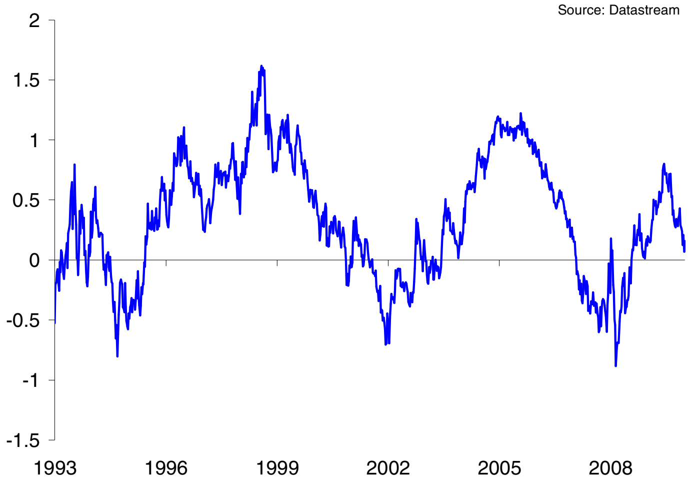


Figure 3: US less Germany (10 year yields, %)

Of course, European yields could rise, after all the simple average of the European yield curve complex, summarised in Figure 4, is 4.6%. However, this is a complex where yield premium is associated with default risk of the non-payment kind, not through inflation.

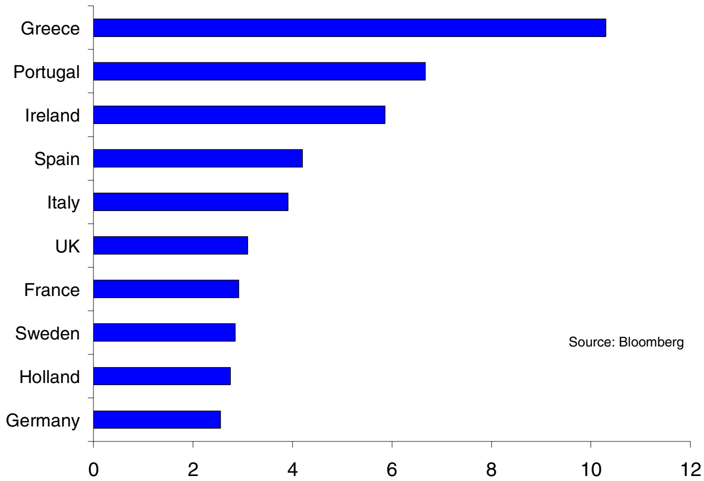


Figure 4: 10 year Government yields (%)

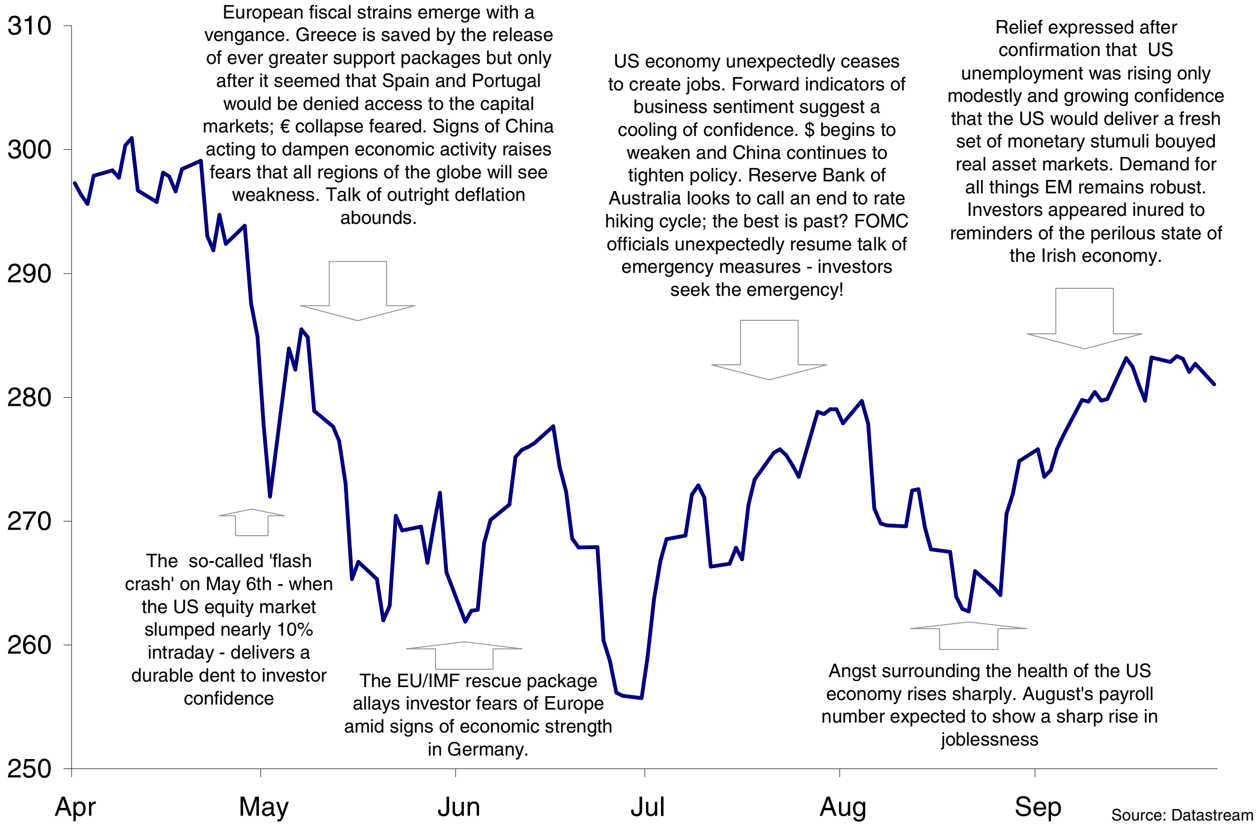
The real cost of funding across peripheral Europe is unsustainable and refunding exercises – such as that which lay behind the Greek crisis of Q2 – must inevitably return; next up is Ireland in Q1, 2011.

Official policy in the US implicitly targets, in the long term, higher long-duration bond yields, through the short-term, QE, mechanism of lower bond yields. Official policy in Europe will eventually address the peripheral problem and, when resolved, this will see German bond yields rise as safe haven premia erode. Therefore, scope exists for the pattern in Chart 3 to be maintained but beneath the surface here, as elsewhere, the reality is anything but normal.

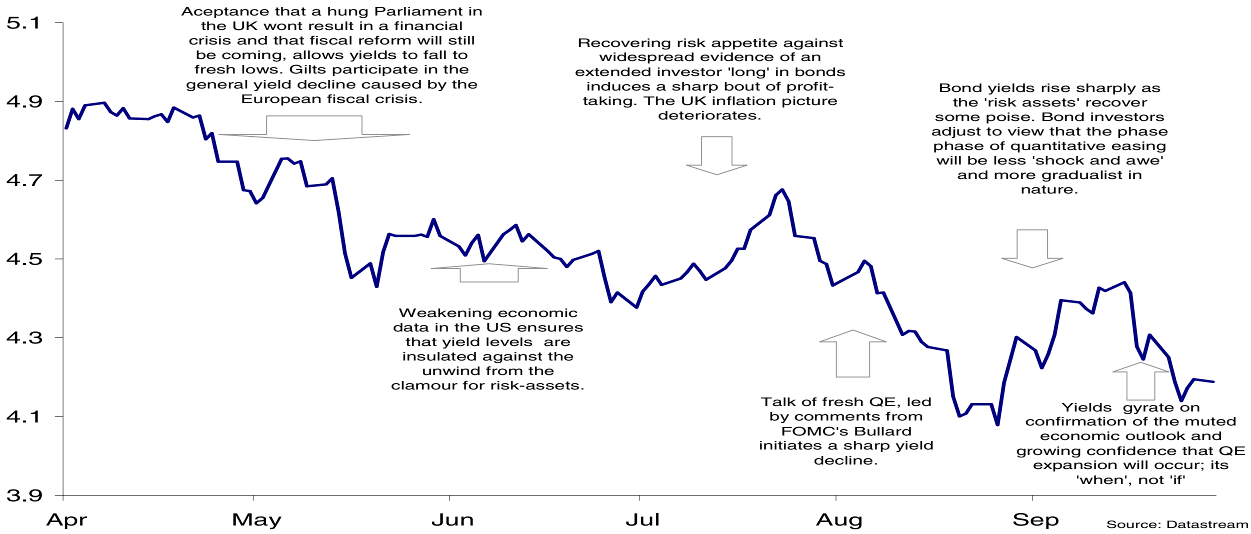
Market 'Postcards'

The next four charts provide an annotated, pictorial summary of moves over past six months.

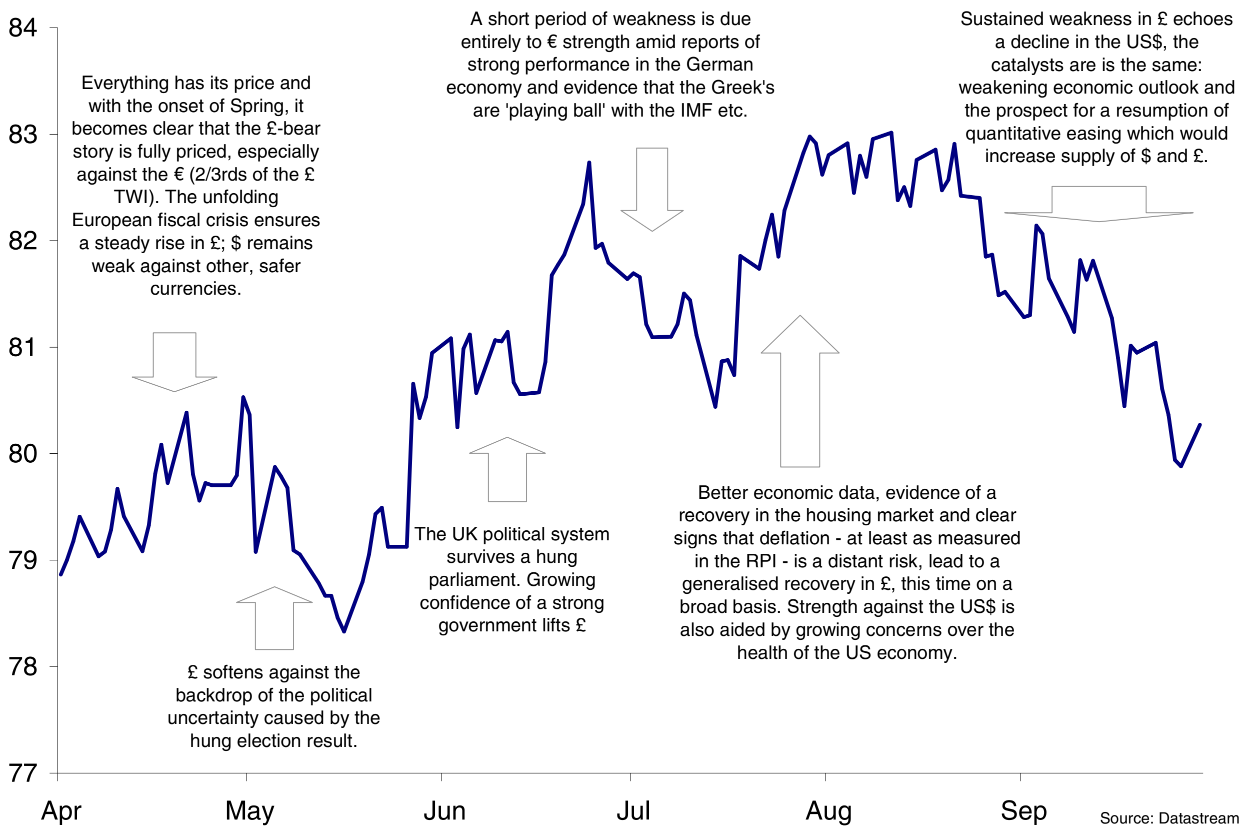
Global Equities:



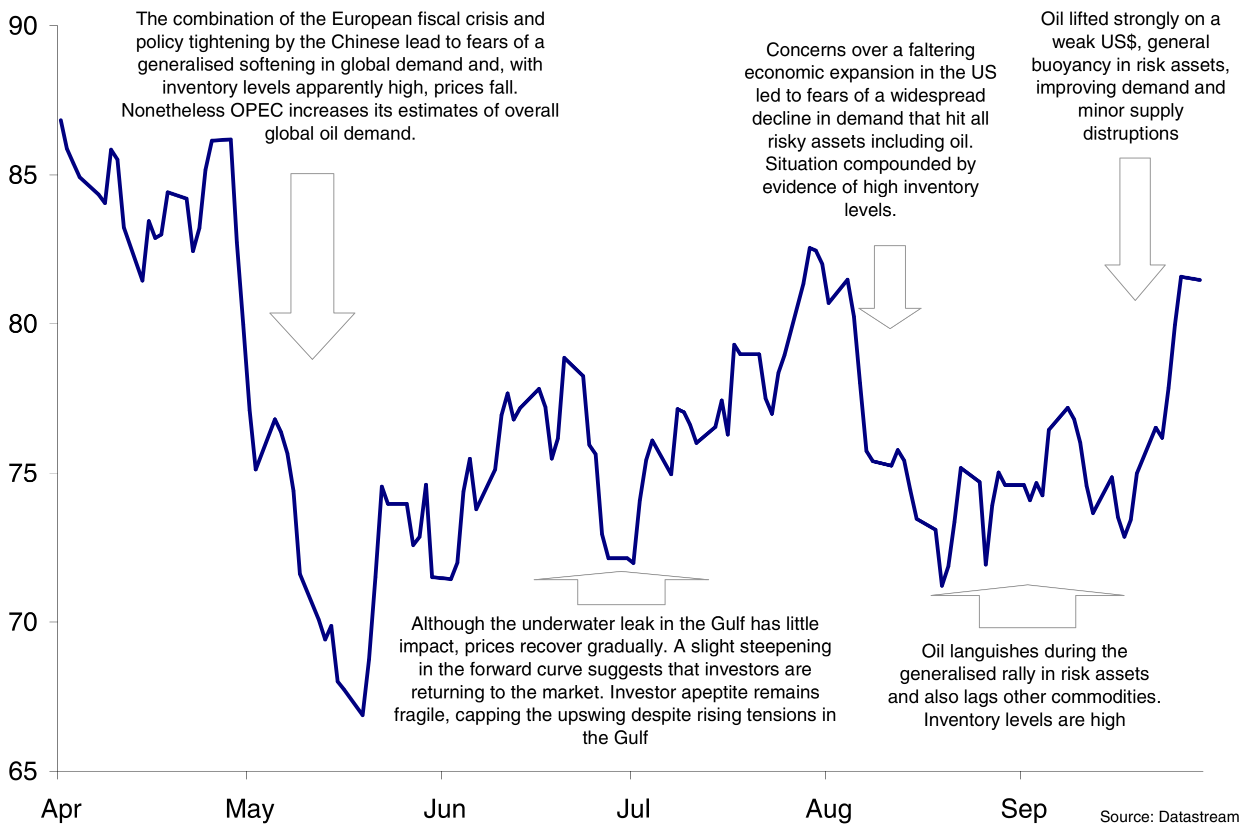
Long Gilts:



£ (Trade Weighted Index):



Oil:

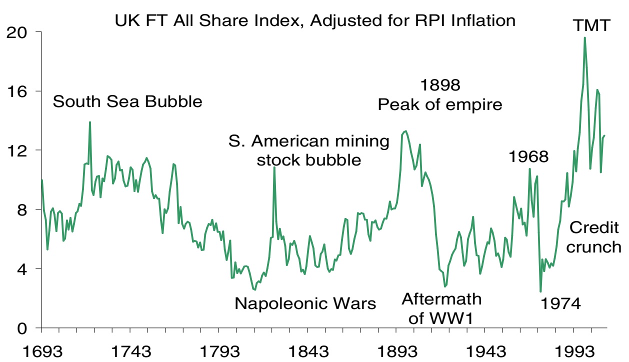


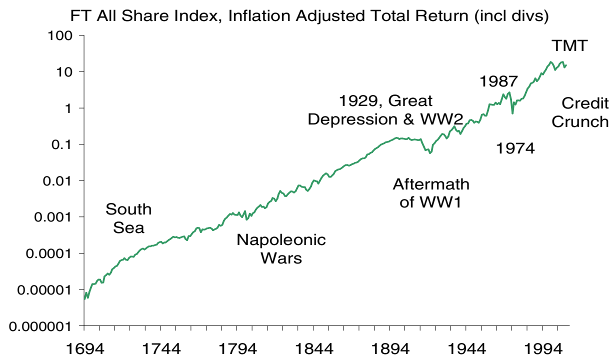
Commentary

Half of the world's 30 largest markets have a dividend yield today that is above the local bond yield. Equities have not consistently yielded more than government bonds since the 1950s. At an individual stock level, there are a number of companies with dividend yields higher than the yield on their corporate bond; 34% of the FTSE has a higher dividend yield than that available of 'AA' credit rated, UK corporate bonds. This too is unusual.

This latter fact could trigger corporations to generate returns for shareholders by attempting to arbitrage this yield gap by raising debt to buy either their own equity via a buyback or to buy other companies' equity via M&A activity. Microsoft has said it will use debt to finance buying back stock. It sold a three-year bond with a record low coupon for an American corporate of 0.875% in September. Its dividend yield is 2.6%. Other companies will consider doing this. Investing in this trend, ahead of it becoming a stampede, could be a profitable strategy.

Dividends have historically comprised the critical part of equity returns; since 1871, dividends in the US have accounted for 90% of the total return of equities. In the bull market years from 1982-2000, equities delivered exceptional returns, with capital return being a bigger component than dividends. However, this was an unusual time and we may be seeing a return to a pre-1982 world where the dividend component was critical. In the UK we have access to stock market and inflation data going back to the 17th century. Over this period, the real return (i.e. inflation adjusted) excluding dividends is just 0.1% per annum (left chart below); the real return on equities is 4.8% per annum when including dividends (right chart).





The statistics above are a reminder that dividend-paying equities are an excellent hedge against inflation. Most significantly, the dividends, unlike fixed coupons paid on corporate debt, should rise at least in line with inflation. This is an attractive consideration at a time when central bankers are so concerned about deflation that they could potentially create inflation via the current extraordinary monetary policies. Any increase in QE programmes could simply compound the risks.

It is impossible to guarantee dividend payments, but it is possible to measure investor confidence regarding payment. The Eurostoxx 50 Dividend Futures market allows investors to trade a futures contract on dividends. The settlement price of the contract is based on dividends paid during the reference period. Therefore, the price investors are willing to pay for the contract before settlement reflects investors' views on the level of dividends that will actually be paid. The Dividend Futures Market sold-off aggressively at the start of May 2010, but it has recovered strongly despite the volatility in the underlying equity index. This suggests increased investor confidence in the payment of dividends even though concern remains about the direction of stock prices.

The overall direction of the market will influence the absolute return on a strategy focused on high-yielding companies. A portfolio of high dividend yielders should have a positive return in a rising market. However, it may underperform as capital return is more likely to dominate (as we saw in 1982-2000) in a bull market. A dividend yield of 4-7% is unlikely to be enough to protect against a negative return in another bear market. However, a well-constructed portfolio of high yielding stocks in appropriate sectors should mitigate the declining capital values in any falling market.

Strategy Guidance

The Pension Fund is inherently ‘long’ risk assets. As such, the Fund is exposed to underperformance of these risk assets and also to a strengthening in bond yields.

1. The severe global economic slowdown still casts a menacing shadow over markets. Sentiment rallied strongly off the lows of last year but was jolted by the re-emergence of the ‘credit crunch’ at the sovereign level in Europe. Investors were given a reprieve by a huge emergency support package. However, as recent US data has shown, job creation is weak in the developed economies. The replacement of systemic issues (Europe) by cyclical issues (US) is not without severe risks. A renewed US downturn would reflect negatively on Europe, limiting Germany’s ability to support the beleaguered southern European states.

2. The fluctuations within markets between ‘risk on’ and ‘risk off’ will continue as investors struggle to cope with the immense policy stimuli and severe structural headwinds. Traditional active equity managers will find it difficult to outperform their indices. The Fund should adjust its expectations accordingly.

3. Movements on foreign exchanges may remain elevated as the health of nations forms a greater part of investor thinking. This will not be good for the Euro. Fiscal retrenchment will limit the ability of Sterling to move higher especially on any announcement of renewed QE but Sterling remains a more attractive currency than the Euro. Our preference to hedge out Euro exposure remains in place.

4. The potential for extreme currency volatility is very high. The re-emergence of QE as an active policy tool and market driver could see ‘protectionist’ issues feature increasingly in the news headlines. This represents both risk and opportunity to the Fund; risk should be avoided and opportunities harvested.

5. Investors remain poorly positioned to absorb any fresh decline in asset markets. However, a sharp rise in liability values is the immediate threat. Ironically, QE (as a measure to cap or lower long-term interest rates) exacerbates the liability issue. The hope is that this will be more than offset by higher prices across all asset markets. A substantial sell-off in financial markets is unlikely, but the consequences will be more severe because of the poverty of remedial policy options. Government bonds are becoming too expensive to hold on any grounds other than risk mitigation. There are better ways of defending portfolios.

6. Official interest rates are set to remain low for some time. Equity strategies targeting higher dividend-yielding stocks will likely outperform over the longer term and provide a useful ‘hedge’ against inflation. The Fund may wish to revisit the nature of its equity benchmarks and/or establish an explicit, higher dividend equity allocation.

7. Systemic and economic fractures must be examined for their potential negative impact on the Fund. Possible areas of specific concern are listed below:

- A strong move towards greater protectionism still cannot be discounted especially in the form of exchange controls in Asian and other emerging economies. See the Appendix for a summary of possible policy moves in currency markets and who is doing what currently (it should be noted that by the time this is read, it will almost certainly be out of date given the pace in current flow of announcements.

- Higher commodity prices threaten to depress disposable incomes and, combined with persistently subdued economic growth, could foster an environment typically characterised as 'stagflation'. This is a poor backdrop for investing generally but specific asset classes (e.g. commodities) can be attractive.

- Led by moves in developing and commodity economies, risks surrounding extrication from the current emergency monetary policy setting are growing.

8. In the face of these risks, policymakers will do whatever is necessary to rebuild confidence and avoid a sharp economic recession. Against this backdrop, risk-free, inflation-protected assets are ideal if priced attractively. Unfortunately, UK index-linked stocks are very richly priced. However, other attractive index-linked markets exist; the Fund should look to take advantage of these opportunities.

Closing Comments

- The global economy remains highly challenged by global imbalances that see the 'west' smothered by a debt mountain and the Chinese economy defined by a 53% (of GDP) savings rate; this is an unsustainable position.
- Policymakers continue to believe that there is a outcome that doesn't involve some form of debt destruction through default; rather they seem inclined to (quietly) favour debt destruction through inflation.
- The Japanese were able to inflict upon themselves 'lost' decades largely because they were a creditor nation; the 'West' are, largely, debtors, and their creditors simply wont allow such an outcome.
- Eventually the West will need to sign up to a grand version of an IVA (Individual Voluntary Agreement). Only then will free capital be able to be durably deployed to risk, in the meanwhile all the evidence suggests that (scarce) free assets are being targeted (impossibly) at liability reduction/hedging.
- As a result, the multi-year outlook is still for a broad, but ultimately trend-less, trading range for equity markets. We will consider timely adjustments to the broad asset allocation. 'Contingency' cover will be important.
- In the short term, the world's most important Central Bank – the US Federal reserve – now targets real economic growth, risk assets and, based on recent comments, inflation. The adage of 'don't fight the Fed' may prove useful for the months immediately ahead but, as and when the European crisis resumes, it is likely that we have not yet seen the

trough in bond yields. Bonds may well prove a poor investment but they could yet prove to be a valuable asset.

Appendix: Summary of Central Bank currency actions and protective measures

	Action	Costs from using these tools to weaken the local currency	Limitation to efficacy	Strengths	Logistics	Countries that have used this approach recently
FX market strategy	Central bank FX buying - selling	Inflation: Local currency liquidity from intervention could push up the local prices	May be perceived by market as unsustainable	Powerful disincentive	Auction vs. discretionary with costs and benefits	Israel, HK. None in Latam for more than 50% of intervention.
	Central bank FX buying-selling/sterilized	Fiscal: Sterilization costs are initially shouldered by the central bank, but eventually passed onto the government	Impact can be diluted by high local yields	Less side effects on money supply and inflation	Auction vs. discretionary. Bill sales vs. repo sterilization	Brazil, Colombia, Argentina, Mexico and Chile, Turkey, SA, Russia, Israel, Poland, Singapore, Korea, most of Asia
	Government FX intervention	Credibility: May be undermined if the Central Bank opts not to intervene (sending a contradictory signal)	Opaqueness would undermine 'signaling effect'. Credibility limited by government asset base	Powerful disincentive	Through state or private sector banks	Chile, Argentina in the past, Brazil with sovereign wealth fund, Poland
	Interest rate shifts	Inflation: Could fuel inflation if economy is at full capacity	Less effective against FX appreciation during climate of low global rates	Reinforces effect of intervention	At MPC meetings or on an *ad hoc* basis	Argentina in 2009 during (small) run on FX, Hungary
	Withholding taxes on non-resident incomes or capital gains and/or Tobin tax on transactions	Administrative costs and may weaken l/t direct investment	Difficult to fine tune. Government may be reluctant to reverse.	Add to fiscal revenue. Tax may help equalize tax burden of locals vs. foreigners	Legislative approval may be needed to implement or remove	Brazil (IOF), Chile withholds income taxes, Egypt, Turkey (2006), Thailand
	Unremunerated reserves requirements on banks or foreign investors	Administrative costs; may weaken FDI. If imposed on domestic banks would raise cost of external borrowing/rollovers - impacts domestic operations	Difficult to fine-tune and impacts local lending/ borrowing	Can tackle short-term flows	Foreigners would need custodial accounts	Chile in the 1990s, Colombia until 2008, Argentina currently