

LONDON PENSIONS FUND AUTHORITY

developing investment strategies  
to improve performance in a  
changing market



# Investment Report

2004-05

## Market commentary - year to 31<sup>st</sup> March 2005

Equity markets enjoyed a good year, supported by strong economic growth and, toward the end of the period, merger and acquisition activity. Increases in short-term interest rates in the UK and US, implemented in response to concerns over the emergence of inflationary pressures, appears to have had little impact on investor sentiment.

In the UK, the FTSE All Share Index advanced by 15.6%. The strongest group was mid size companies, +17.1%. Large and small companies performed less well, +15.4% and 12.9% respectively. Value stocks advanced by 18.0% compared with the more modest 12.8% achieved by growth stocks, extending the trend in favour of value to 5 years. In general the corporate sector was strong with the major clearing banks, including HBOS, HSBC, the Royal Bank of Scotland and Barclays, and major oil companies, Shell and BP, announcing significant profit increases during 2004.

In contrast, certain retailers including Marks & Spencer and Boots struggled to maintain market share in a very competitive sector.

Expressed in local currencies, overseas equity markets produced mixed returns. Europe (ex UK) rose by 15.1% and North America by 7.3%. For UK investors, European equity returns were enhanced (to 18.6%) by the appreciation of the Euro against Sterling, but Dollar depreciation reduced returns from North America to 4.8%. Japan advanced by a modest 1.2%, reflecting the uneven pattern of economic growth during the year. Pacific markets (ex Japan) rose by 12.3%.

Despite the rise in short-term interest rates, long dated bond yields, in both the UK and US, declined for much of the period. In a now famous speech made in February 2005, the Chairman of the US Central Bank stated that 'the broadly unanticipated behaviour of world bond markets remains a conundrum'. From that point, yields on long dated bonds in the US and UK increased, as markets started to focus on the implications of increasing inflationary pressures. The reversal of the prolonged decline in long bond yields had a modestly beneficial impact on pension scheme funding levels.

In the March Budget, the Chancellor announced the creation of a fifty year, fixed interest gilt. The first issue will be in late May; an Index-Linked issue of similar maturity may follow in October. These bond issues will appeal, amongst others, to insurance companies and pension funds seeking to match long term liabilities with more appropriate assets, in addition to enabling the Government to lock into historically low nominal and real interest rates for a long period.

In currency markets, the long slide in the US dollar was arrested during the first quarter of 2005 but the currency still declined by 3.5% on a trade weighted basis between March 2004 and March 2005.

Comments from certain Central Banks on the need to 'diversify' their asset base merely acted to unsettle the Dollar and raised fundamental questions over its future direction. The twin deficits (current account and fiscal) continue to threaten the long term stability of the Dollar.

The price of oil was a major concern to investors as it touched record levels and encouraged forecasts that it might reach \$100 per barrel sometime during 2005. Market participants are not sure about the impact of higher oil prices on activity and inflation; the depressing impact of lower economic activity might compensate for the direct inflationary pressures.



## Introduction

Last year's report focused on the new LGPS regulatory environment and in particular the emphasis on the requirement for consultation on future funding with those who finance pensions via the employer contribution in preparing a Funding Strategy Statement. This year deals more with investment of the fund as an integral element of the funding strategy.

LPFA's response to the Myners Investment principles has developed over the year and the first part of this report addresses performance of the Authority in the decisions and actions taken, of its advisers, and provides an overview of the reports made by each investment adviser.

## Review of performance on decisions and actions

The Investment Strategy Committee met on five occasions and considered 53 reports. They also held a special meeting with the actuary to consider valuation assumptions, a separate training day and an away-day session to review strategy. A review of performance is given against strategic objectives and key tasks.

## Meeting standards

The investment objective to maintain the solvency of the fund and to hold contribution rates low and steady was not achieved in the three-year valuation period to 31<sup>st</sup> March 2004, due primarily to a significant and prolonged downturn in world equity markets.

Investment management arrangements and fee structures were reviewed in January and action deferred to the full review of strategy.

## Optimising efficiency and effectiveness

New arrangements for the administration and custody of London County stocks were agreed and implemented through Computershare, the global share registry.

## Review of investment strategy

A fundamental review of investment strategy was undertaken at the away-day in March in the light of the valuation outcomes, and significant changes were agreed, together with an implementation plan and risk framework ~ see details on page 11.

A re-assessment of valuation assumptions was agreed with the actuary in the early stages of the valuation process and employers informed. Specific asset class reviews were undertaken on structured solutions, alternative assets, and cash-flow matching of bonds and index linked gilts.

The overall funding strategy was developed in consultation with employers and the Statement published in February in accordance with the regulations.

Options for a long term investment model were considered as part of LPFA's involvement with the Marathon Club in the autumn.

## Governance structure

Investment decision processes were reviewed as part of a new governance framework.

A new policy statement on active and responsible investing was agreed, incorporating a series of collaboration and engagement initiatives. The new policy was published in a revised Statement of Investment Principles following consultation.

The Committee maintained a quarterly monitoring process of compliance matters and these are referred to later in this report in more detail.

## Familiarity and training

A programme of learning sessions has been conducted throughout the year involving presentations and research on asset classes and investment styles.

As part of the Board appointment process, competency statements have been drawn up for each Member itemising their core skills, experience and training, expressed in hours.

## Review of investment advisers

The Committee's two independent investment advisers and the fund actuary attend all meetings of the Committee to provide guidance and advice on a wide variety of investment matters. The advisers also attend monitoring meetings with the external investment managers.

Their input has proved invaluable in a number of areas, in particular the build-up of a portfolio of alternative assets, stock lending, custody, transaction cost monitoring, and the review of investment strategy.

As part of their responsibilities the two investment advisers each provide an annual report on the past year's activities as summarised below.

## Investment advisers' overview

Both advisers refer to an improvement in the decision making process due to the greater frequency and timeliness of meetings as recommended last year. The quality of information provided to Members is considered high and they come to meetings well prepared. The quality of debate is thus enhanced and decision making more effective.

The away-day session to review investment strategy was considered both fruitful and extensive. A number of alternative and radical strategies emerged, recognising the asset/liability dynamics and risks involved. The process of implementation will be challenging and time consuming. The new style mandates will need to be understood and the processes evaluated before fully effective monitoring can continue.

Comments were made on the performance of individual managers with the expectation that new investment style mandates will give the potential to enhance returns for both sub-funds.

Both advisers refer to the strength of the in-house team in the amount of work undertaken and quality of output, and thank them for their support in delivering the advisory role.

## Funding and investment strategies

With the certain prospect of under-funding emerging from the valuation at 31<sup>st</sup> March 2004, considerable time was devoted in the year to ensuring accurate data, reviewing financial and demographic assumptions, developing a long term and viable funding strategy with the actuary, and consulting employers on the impacts and options.

It was a long process partly because of the need for consultation, but mainly because investment returns, in common with all pension funds, were poor over the actuarial period. This has required some delicate decisions, balancing the spreading of deficits over a period of time, together with phasing in higher contribution rates on a basis which was both reasonable and open to public scrutiny. Valuations for individual employers were completed by the statutory deadline of 31st March 2005.

The principal reasons for the downturn in funding levels include:

- ~ Under-performance of global capital markets leading to returns in the valuation period falling some 30% below the actuarial assumptions.
- ~ High gilt yields in a low inflation environment.
- ~ Longevity and changing demographics as they impact on liabilities, including rising salary levels and early retirements.
- ~ The slow recovery of employer contribution rate levels from periods of pension fund surpluses.

Future strategy will be linked closely to the liability profiles that have emerged from the valuation process and by the solvency position of individual employers. This will inevitably lead to a longer term view of investment to generate returns related to liabilities and funding, rather than in relation to other funds or market indices. Investment returns need to be increased whilst not further increasing risk unduly.

The Board has recently reviewed its investment strategy and has initiated an open tender process for new style portfolios and managers. The main proposed changes are detailed on page 11.

### Financial assumptions

	Mar 2004 % p.a.	Real % p.a.
Investment Return /Discount Rate		
Active Sub-Fund	6.30%	3.40%
Pensioner Sub-Fund	6.20%	3.30%
Pay Increases	4.40%	1.50%
Price Inflation /Pension Increases	2.90%	-

### Fund valuation as at 31<sup>st</sup> March 2005

31.3.2004 £'000s		31.03.2005 £'000s
368,198	Fixed Interest Securities	353,509
964,483	Equities	995,288
937,153	Index-Linked Securities	862,332
361,592	Managed & Unitised Funds	436,754
80,486	Property Unit Trusts	111,328
4,524	Private Equity	43,449
78,281	Cash and other	186,860
2,794,717	Total Net Assets	2,989,520

## Strategic asset allocation

The table below shows the current asset allocations against the long term targets set in 2002. Apart from the diverging impact of changes in market values and a redemption of an index-linked gilt, the main change is the build-up of alternative assets, as explained below.

### Alternative assets

The strategic policy aimed at diversifying some 15% (or currently £240m) of the asset base of the active sub-fund away from equities and into alternative assets continued during the year. Whilst some other asset classes, such as commodities, are currently under review, the current main asset classes are as follows:

#### ~ Property Unit Trusts (PUT's)

A £100m investment, representing some 7% of the fund, was made in five major PUT's between September 2003 and effectively June 2004. These trusts provide exposure to actively managed and broadly diversified portfolios of commercial, office and industrial property in the UK. Coupled with an attractive yield, they are also, as trusts, a far more cost effective and marketable means of holding property than could be achieved by physical direct property investment.

The net asset value performance of this portfolio has been very good (+12.95%) since inception. Additionally, it enjoys a current yield of 4% p.a. There are no current plans to increase exposure to this asset class.

#### ~ Private Equity Funds

Following a detailed and comprehensive selection process, three private equity fund of funds managers were chosen in October 2003 to create and manage portfolios within an agreed sector and geographical

strategy. The overall commitment to the first programme with this asset class was set at some £125m. It is envisaged that every 3 years an extension programme will be instituted, in order to maintain the exposure to the asset class.

The higher returns which historically have been achieved from this asset class must be measured against the extended length of time it takes to fully realise the investments. The average life of the funds is between 12 to 15 years and it will probably take up to 5 years to commit the money. The process is further complicated by distributions from realisations, sometimes as early as 2 years after commencement. The probability is that only about 50% to 75% of the commitment will actually be invested.

Over the year, and to bridge the gap caused by the timing of drawdowns and the need to maintain the exposure to the sector, two tranches of investment, mainly in publicly quoted Private Equity Investment Trusts, and totalling some £60m were completed. The plan is that these will be reduced over time as calls increase. They effectively enable control of the exposure to the sector.

The sector strategy of the first programme is broadly as follows: 25% in venture capital / 50% in medium and small buyouts / 25% in secondaries and/or mezzanine financing. The broad geographic split is 60% North America / 40% Europe.

#### ~ Private Finance Initiative (PFI)

The LPFA's exposure to this sector has been increased over the year in terms of commitment if not materially in actual investment, with an investment in the Henderson PFI Secondary Fund.

## Asset allocations

	Active sub-Fund	Target	Pensioner sub-Fund	Target	Total Fund 2005	Total Fund 2004
	%	%	%	%	%	%
Fixed Interest	11	15	20	20	15	13.5
Index-Linked	0	0	58	67	27	33.9
UK Equities	35	35	9	6.5	23	22.5
Overseas Equities	40	35	7	6.5	25	25
Alternative Assets	10	15	0	0	5	2.9
Cash	4	0	6	0	5	2.2
	100.0	100.0	100.0	100.0	100.0	100.0

## Investment performance

The WM Company measures the investment performance of the sub-funds based on reconciled transactions data supplied by the custodian.

The asset allocation encapsulated in the benchmarks is designed to spread the risk and minimise the impact of poor performance in a particular asset class. It seeks to achieve a spread of investments across the main asset classes (e.g quoted equities, fixed interest, private equity and property) and geographic regions within each class, as appropriate to the type of fund. The pensioner sub-fund is mature with an emphasis on income (mainly bonds), while the active sub-fund is relatively young and has an emphasis on growth (equities).

#### For the financial year (1 year)

- ~ The Pensioner sub-fund produced a return of +6.1% against a benchmark performance of +6.3%. This 0.2% relative under-performance was attributed to asset allocation -0.1% and stock selection -0.1%.
- ~ The Active sub-fund produced a return of +10.7% against a benchmark return of +11.9%. This 1.2% relative under-performance was attributed to asset allocation -0.6% and stock selection -0.6%.

#### For the medium term (3 years)

- ~ The Pensioner sub-fund produced a return of +6.6% against a benchmark return of +6.3%. This relative 0.3% out-performance was attributed to asset allocation +1.1% and -0.8 to stock selection.
- ~ The Active sub-fund produced a return of +0.6% against a benchmark return of +2.3%. This relative 1.7% under-performance was attributed to asset allocation -0.8% and stock selection -0.9%.

#### For the longer term (10 years)

- ~ The Pensioner sub-fund produced a return of +8.0% against a benchmark return of +7.9%.
- ~ The Active sub-fund on the other hand, produced a return of +5.5% against a benchmark return of +7.0%. It should be noted that the portfolio structures and benchmarks have changed significantly over the 10 years.

#### Performance summary as at 31<sup>st</sup> March 2005

	1 Year	3 Years	10 Years
Active sub-Fund	10.7	0.6	5.5
Benchmark	11.9	2.3	7.0
Pensioner sub-Fund	6.1	6.6	8.0
Benchmark	6.3	6.3	7.9
Total Fund	8.5	3.6	6.7
WM All Funds (average return)	11.6	3.7	8.0
RPI (broadest measure)	3.2	3.0	2.6

## Compliance reporting

### Manager accountability meetings

Since September 2003, mid-quarter meetings have been held with the active investment managers, Hendersons and Goldman Sachs. These meetings are conducted by the LPFA investment team and are intended to analyse and review the progress and, more importantly, the process by which the funds under management are managed. Topics covered include such items as the make-up of the portfolio (by geography and sector), the level of turnover, the costs of settlement, changes in the management team, attribution analysis, relevant economic and political developments, trading and performance. These meetings are held at the managers' offices and are attended by the respective actual managers of the funds.

It also provides a useful opportunity to directly convey any concerns that the LPFA Board / ISC might have, as well as learning of new developments or changes at both these managers. A full report together with statistics is presented to the next ISC following the visit.

The system has worked well, but changes will be required next year to cater for the increase in the number of managers following the award of the new mandates.

### Treasury management

This relates to the overall management of all the LPFA's cash investments – money market funds and other externally managed cash funds. Essentially, there are currently three elements.

- ~ Sector Treasury Services' appointment as adviser on the placement of monies co-incided with the redemption of a large index-linked holding in October 2004. Their primary advice was to place £60m with Royal London Asset Management (one year mandate), £40m with Bank of Scotland and £20m with Abbey. The last two although instant access accounts both pay higher than average interest rates.
- ~ The previous policy of treating all 3 money market funds on a broadly equal basis, was altered by Sector to reflect concentration on the highest one year simple yields. In reality, and within operational constraints, this has resulted in the funds of Fidelity and Barclays transacting broadly similar cash balances whilst that of JP Morgan Chase has been minimized.
- ~ LCC Loan Stock monies. The repurchase by means of a public tender of the two loan stocks originally issued by the London County Council was planned and initiated in the year, and eventually completed in June 2005.

Market value of Fund (£m) at 31<sup>st</sup> March 2005



## Corporate governance

During the year under review, the LPFA voted in favour of 633 resolutions and against 346 resolutions in UK companies. Letters are now sent to all companies where resolutions are opposed with an explanation of the reasons, consistent with in-house policy described in a Code of Practice on the exercise of voting rights. This conforms with the NAPF 2004 corporate governance template.

The Board appointed Manifest for an initial 12 month term to June 2005 to provide a UK Research and Voting Service. This primarily consists of the provision of voting intentions, and supporting business meeting reports, for all UK constituent holdings, vote lodgement and voting reports.

Research is currently being undertaken to determine the prospects and costs of voting overseas and establishing proposals for practical voting policies in these markets.

LPFA, as a member of the Local Authority Pensions Fund Forum (LAPFF), receives research and advice in relation to voting issues and company good practice. Through LAPFF, and through membership of NAPF and IIGCC, LPFA is able to engage actively with companies to enhance the process already operated by its external managers.

Voting action is an integral part of being an active and responsible investor. LPFA's policy in this respect were reviewed, revised and published in an amended Statement of investment Principles. One particular aspect of this new policy defines the responsibilities of the investment managers, and they were consulted on the changes which reflect the guidance issued by the Institutional Shareholders Committee.

A US legal firm, Lerach Coughlin Stoia and Robbins LLP, has been retained for the provision of portfolio monitoring of the Fund's US holdings to identify, and potentially thereafter seek to recover, losses due to breaches of US securities laws ("Class Actions").

## Securities lending

UK Gilts, International Equities and, since last year, UK equities are lent through an indemnified programme managed by JP Morgan. The proportion of current value of loans to available portfolio value is about 10% or approx. £200m, and well within the requirements of the LGPS 1998 regulations which have a 25% upper limit. The improving income stream from UK equities should offset at least some 70% of custodial fees on a regular quarterly basis. The efficiency of the programme was reviewed independently during the year by Data Explorers, and some changes in policy and practice introduced as a result.

## Custody and banking

As reported last year, the existing global custodian J P Morgan Chase, were re-appointed (1<sup>st</sup> April 2004) following a comprehensive tender process and market review on considerably improved service terms to the LPFA. Thomas Murray, the specialist custody firm who had assisted in the tender process were appointed to monitor and report on JP Morgan Chase's performance for one year as part of their "PROBE" service.

## Geographical analysis of equity holdings As at 31<sup>st</sup> March 2005

Region	£m	%
Overseas		
~ North America	301.1	30.25%
~ Europe	166.6	16.74%
~ Far East	66.9	6.72%
~ Japan	72.0	7.25%
UK	388.6	39.04%
Total Equity Holdings	995.2	100%

## Transaction costs

All external managers comply with the IMA transaction cost disclosure code and report quarterly. Their reports are analysed by Analytics and considered by the Committee.

The LPFA's relationship with Analytics, to report on the total transaction costs incurred by the investment managers, was formalised with an initial one year contract in September 2004. They report both explicit (brokerage /commission and stamp duty) and implicit (impact/timing) transaction costs which are measured against industry benchmarks, and analysed against asset class, fund manager and broker.

The data provided by Analytics has improved transparency with identifiable and measurable transaction costs incurred by investment managers on LPFA's account.

This, in turn, has led to enhancements in the overall monitoring process with;

- ~ a greater understanding by the LPFA of the trading process implemented by the investment managers, and
- ~ an awareness by the investment managers that their trading strategy is being actively monitored on a quarterly basis by the LPFA through the Analytics analysis.

## Trustee training

LPFA supports the practice of regular training to ensure trustees are sufficiently familiar with the issues on which they are required to make decisions. This is achieved by trustees attending training seminars, workshops and conferences provided by external providers, including the National Association of Pension Funds. Internally Members have presentations from the Fund's investment managers, separate training sessions on specialist issues, and receive reports submitted by officers.

## Myners compliance and SIP

The central proposal to emerge from the Myner's Review of Institutional Investment published in 2001 was the establishment of a set of non-mandatory (but accountable) principles to improve practice and process in institutional investment management. These principles have been reviewed and revised recently by HM Treasury.

Under the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1999, as amended in 2002, the Authority is required to report its compliance with Myners principles in the Statement of Investment Principles (SIP), and complies fully.

## Compliance with Myners principles

1. Effective decision making	Full
2. Clear objectives	Full
3. Focus on asset allocation	Full
4. Expert advice	Full
5. Explicit mandates	Full
6. Activism	Full
7. Appropriate benchmarks	Full
8. Performance measurement	Full
9. Transparency	Full
10. Regular reporting	Full

## Largest equity holdings As at 31<sup>st</sup> March 2005

Shares in issue	Market value £m
BP	£34.3
Vodafone	£25.5
Glaxosmithkline	£17.5
Barclays	£17.2
HSBC	£16.7
Lloyds TSB	£15.1
BHP Billiton	£14.5
Shell Transport & TRD	£13.2
Astrazeneca	£12.8
HBOS	£12.0

## Review of long-term investment strategy

On the basis of the valuation results and funding strategies agreed with employers, the Board has reviewed the investment strategies, portfolio structures, benchmarks, risks and management arrangements for each of the Sub-funds.

In overall terms, the strategy needs to deliver higher investment returns which can be sustained over the longer term to recover under-funding and stabilise employer contribution rates.

### Active sub-Fund

The tables below show the broad changes in asset allocation agreed and which are currently subject to an open public tender process.

The changes re-enforce the belief that equity returns will add value over time ~ the valuation assumption is an equity risk premium of 2%, i.e. the amount by which equities will outperform bonds.

A more defensive allocation to bonds at a time of underfunding would lock in deficits and reduce the scope to recover full funding.

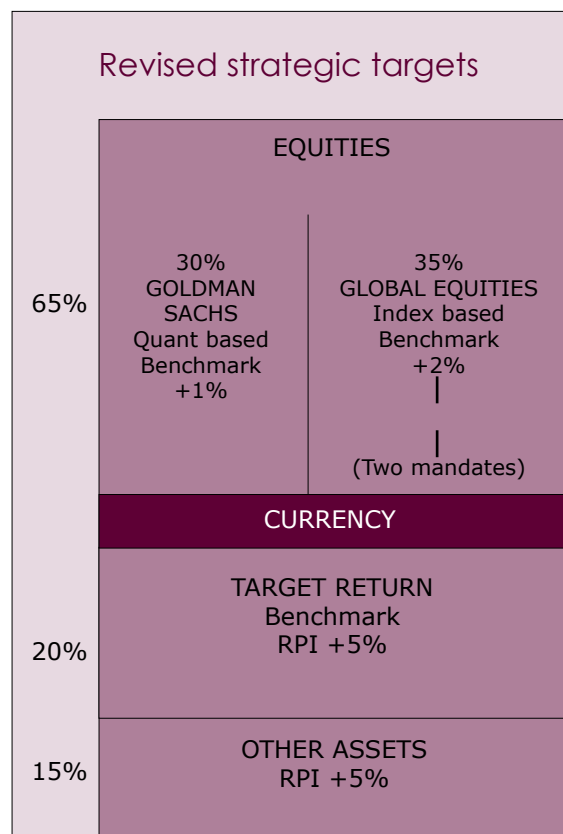
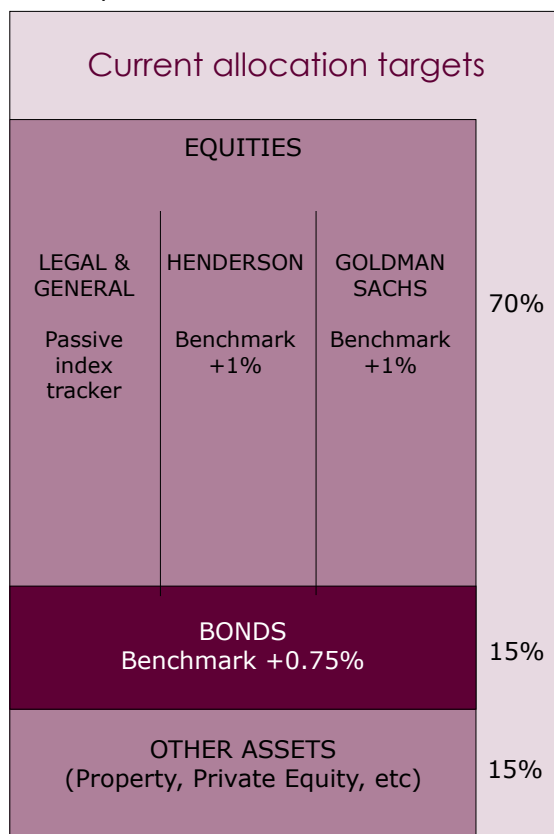
The changes, therefore, show a minor reduction in the equity target from 70% to 65%, comprised of a higher weighting in the GSAM quant mandate (20% to 30%), a more aggressive global equity mandate(s) with an out-performance target of +2%, and a currency overlay mandate to reduce risk to currency movements.

The allocation to bonds (15%) is replaced by a new mandate (20%) with a target return of inflation (RPI) +5%. This portfolio will contain a mixture of assets (including bonds), managed to deliver positive returns in excess of the liabilities.

The allocation to other assets of 15% is unchanged but the components, principally property unit trusts and private equity will be reviewed to ensure cash is invested on a timely basis and for added returns.

### Pensioner sub-Fund

The overall asset allocation within this sub-fund is still under review as liabilities and contribution income streams are finalised. However, the expectation is that revised management arrangements will be introduced to secure overall returns of index linked gilts +1.5%, while continuing to match cash flows in the medium term. Potential managers will be drawn from the current tender process.



London Pensions Fund Authority  
Dexter House  
2 Royal Mint Court  
London EC3N 4LP

[www.lpfa.org.uk](http://www.lpfa.org.uk)