

Investment Report

London Pensions Fund Authority



Highlights

- Fund value rises to £3.5 billion
- Strong equity market performance and some recovery in bond yields
- Higher return generating strategy in place
- Successful transition to new managers
- Investment Plan achieved
- Long term investment returns flat
- First quarter returns on new mandates encouraging
- New performance targets set net of fees
- No breaches of policy reported
- Full compliance with Myners principles achieved

2005-06

Market commentary - year to 31st March 2006

Global equity markets performed well during the year to end March 2006, supported by strong corporate results and merger activity, particularly in the UK and Europe.

In the UK, the 'All Share' index rose by 28%; by the end of the period, the FTSE 100 index had just regained the 6,000 level for the first time in five years. The best performing sectors were Industrials and Basic Materials; +54.2% and +48.9% respectively. The poorest performing sectors were Telecommunications, +1.4%, and Consumer Services, +16.5%.

In overseas markets, Japanese and European (ex UK) equities advanced by 50.1% and 34.7%, respectively, in local currencies; North America advanced by a more modest 13.9%. Emerging markets achieved the strongest returns, rising by 62.1% in local currencies over the period.

In bond markets, ten year benchmark yields fell in all major financial centres during the early part of the period. In the UK, demand from pension funds and insurers, and the actions of certain hedge funds, drove yields on ultra long-dated fixed interest and index-linked gilts to record lows in mid January 2006. Although this sharp downward spike was a UK phenomenon, it did, nevertheless, coincide with the low point in bond yields globally. Since that January low point, yields have risen strongly, reflecting concerns over inflationary pressures arising, in the main, from the sharp rise in energy and metal prices.

This more recent rise in bond yields, over a period when equities also rose, has delivered a welcome improvement in pension scheme funding levels.

In the US, short term interest rates were increased, in eight stages, from 2.75% to 4.75%. The Central Bank has now indicated that the current cycle of rate increases is close to an end but also stated that further tightening may be required, depending on market developments. Consequently, most observers forecast one further rate rise, to 5%. Short-term interest rates were also raised in the Euro zone but on a more modest scale, from 2% to 2.5%. In contrast, the Bank of England implemented one reduction in August 2005, from 4.75% to 4.5%. Perhaps of greater significance, the Japanese Central Bank announced the end of its policy of zero short-term interest rates, on continuing signs of economic recovery and evidence that deflationary pressures have, at last, been overcome.

In the March 2006 Budget, the Chancellor forecast UK economic growth of between 2.0% and 2.5% for this year and between 2.75% and 3.25% in 2007 and 2008. The obvious threat to these forecasts is the combined impact of higher commodity prices and the higher interest rate environment.

Against this background, it will be interesting to see whether equity markets can sustain recent high levels.

Prepared by:
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6th June 2006
For and on behalf of Hymans Robertson LLP



Market value of Fund (£m) at 31st March 2006



Introduction

The investment report for 2004-05 focused on the outcome of the valuation, the development of a sustainable funding strategy (published in March 2005), and the early stages of a substantial overhaul of the current investment strategy and management arrangements.

As referred to in more detail later in this report, 2005-06 was dominated by the process of review and implementation, the transition of assets to new manager mandates and structures, and setting in place new monitoring arrangements between the Board, managers and the in-house investment team.

The process was completed satisfactorily and to time. With the new arrangements still bedding down at the end of the year, work continues to strengthen the in-house team to achieve the most effective and efficient governance arrangements.

Review of performance on decisions and actions

The Investment Strategy Committee met six times during the year and considered 61 reports covering investment strategy, management and monitoring, a review of Responsible Investment Policy, a revised Statement of Investment Principles, and compliance reports covering treasury management, corporate governance, securities lending, transaction cost disclosure, custody, the performance measurement service, the investment website and Freedom of Information.

The Committee also held two special meetings to consider tenders for the new investment mandates and the appointment of a transition manager.

The Committee agreed an investment plan at the start of the financial year and action achieved is reported below:

Evaluate current in house arrangements
Revised arrangements were reported in November to be developed further in line with new manager monitoring arrangements. Responsibility for the in-house team was assigned directly to the Chief Executive and a new post of investment director agreed for appointment in July 2006.

LGC stock redemption

The exercise to buy back stockholdings was completed in June with an 86% takeup, and yielded a profit of some £20m on the consequential sale of War Loan stock.

Alternative assets

New opportunities were evaluated and reported through a series of in-house seminars. Responsibility for detailed implementation was delegated to the Chairman in consultation with the advisers and officers.

US shareholder litigation

Revised arrangements were researched and reported ~ see later section in this report.

Manifest voting service

Contract reviewed and extended for one year.

Review role of independent advisers

Review completed and contracts extended for two years to February 2007

Revise Statement of Investment Principles

Current SIP reviewed and revised to reflect new investment strategy ~ revised version published in February 2006.

Transaction cost disclosure

Monitoring arrangements by Analytics reviewed and replaced by direct data transfer from managers with effect from January 2006.

Freedom of Information

With the majority of requests relating to investments, these were reported to each meeting of the Committee.

Investment communications

The website has been reviewed and enhanced to provide a regular update of standardised monitoring information. Employer Forums were used to communicate changes in investment strategy. An explanatory paper on the new arrangements was prepared and circulated to the press, employers and other interested parties.

Build investment manager relationships

Arrangements for quarterly meetings with managers were introduced in January and the outcomes are reported to Committee.

Revise compliance processes with managers

All areas reviewed and are being developed through the monitoring meetings. LPFA policies on responsible investment, voting and procurement were built into the tender documentation and the final investment management agreements.

Instigate formal monitoring of new managers

Implemented from January 2006 ~ see later section in this report.

A revised plan for 2006-07 was agreed by the Committee in March 2006.

Review of investment strategy

This section outlines the background to the investment strategy review undertaken by the Board of the London Pensions Fund Authority (LPFA) during 2005 and provides further information on:

- Key strategic decisions and advice taken
- The process
- New mandates

Background

The exceptional period of poor global equity market returns from 2000 to 2003 affected the Fund's overall investment performance and managers were not meeting targets. This had a significant impact on asset values in the triennial valuation.

The way the investment portfolios were structured and the use of index benchmarks was not encouraging our investment managers to actively seek performance.

Liabilities were increasing due to low bond yields used by the actuaries to calculate their value and because pensioners were drawing their pensions for longer through early retirement and longer life expectancy.

In 2002, the Board set new asset allocation targets. The main change was a shift from quoted equities to alternative assets. However, progress on implementing these changes was hampered by low equity prices.

The actuarial valuation as at 31st March 2004 revealed a substantial deficit in the Active Sub-fund (74% funded), and a significant deficit in the Pensioner Sub-fund (91% funded).

The policy of holding a very substantial portfolio of index linked gilts to match pensioner liabilities had proved to be only partially successful, for reasons of longevity and increased liability values caused by falling gilt yields. The poor returns on the small (15%) equity holding compared to expected returns, had exacerbated the position.

The introduction of a Funding Strategy Statement in 2004 required a fresh look at investments in relation to those liabilities, taking account of the ability of individual employers' to meet their share of the cost in higher contribution rates.

Key strategic decisions and advice taken

The Board decided on a fundamental review of investment strategy. This took place over a two day period during which the Board agreed an overall investment plan of activities for 2005-06.

LPFA is a long-term, responsible investor and takes decisions in regard to investment strategy on a prudent but practicable basis, assessing risk over a time horizon which is consistent with liability profiles.

Hymans Robertson (as the scheme actuary) was appointed to guide the review throughout and manage the public procurement process.

The Board was also advised in the process by the officers, the independent advisers, and received a presentation from an investment manager on liability driven investment processes.

The actuary provided detailed analysis of the liabilities and the risks involved both in different investment strategies, and in different types and combinations of investment management approaches.

It was also agreed to identify and appoint suitable legal advice and support, and to establish a budget for the costs of the process.

After endorsing the continuing split of the Fund between Active and Pensioner Sub-funds for investment purposes, the Board decided not to make any significant changes to the asset allocation in the current strategy, but agreed a radical change in the structure and management arrangements of the investment mandates.

For the Active Sub-fund, it was agreed to maintain the assumption that equities will outperform bonds over the long term. The allocation to quoted equities was reduced in favour of absolute return portfolios.

The Pensioner Sub-fund requires an investment return of approximately 1.5% above the projected cash out-flow to meet the deficit revealed by the actuarial valuation. To meet those requirements, Hymans advised a more aggressive investment policy for the largely passive index linked gilt portfolio.

The process

The Board followed a procurement process using the European Community directive guidelines for selecting asset managers.

At an early stage in the process, a transition manager was selected and appointed, so that the transition plan would be in place for when manager appointments were decided.

After expressions of interest were obtained for the new mandates, long-lists of potential candidates to be invited to tender were selected by a meeting of Board members and advisers using information and selection criteria supplied by Hymans. The tender submissions were whittled down to short-lists for interview following the same process. At the same time, a transition manager was selected, following interview, from a short-list recommended by Hymans.

The manager selection process was intended to result in the appointment of managers with differing investment styles to further enhance risk diversification.

All short-listed candidates were interviewed by Board Members and advisers, and assessed on common criteria. All Board Members were invited to participate and all interview meetings were well attended by a variety of members, and one or both advisers. The representative from Hymans was present at all meetings.

At the end of each meeting, preferred managers were agreed for recommendation and these decisions were reviewed at a special meeting prior to the full Investment Strategy Committee meeting.

All managers were approached to discuss fee calculations and to seek reductions. Further discussions were also held to obtain additional explanations from some managers on investment process.

Three mandates the European Credit Management (ECM) mandate and the two target return mandates for Merrill Lynch and UBS were subject to extra due diligence in view of the differences to what have hitherto been accepted as investment norms. These meetings also helped frame the investment management agreements.

The decisions on manager selections and mandates were put to a full meeting of the Board on 6th October for consideration and approval. Following that meeting, the existing managers were given notice of the changes that had been agreed and the transition process started, managed by the Merrill Lynch TRIM team.

The transition of assets was undertaken on a confidential basis due to market sensitivity but details were published, subject to any commercial interests, once that process was complete.

A full report on the transition process reviewing the outcomes, process efficiency and costs incurred has been considered.

The portfolios created for the new mandates were handed over to each manager, effective from 1st January 2006.

New monitoring arrangements have been put in place to reflect the more diverse structure of the portfolios and the number of managers involved.

The role of Board members in the monitoring process will be reviewed, including the frequency and length of Investment Strategy Committee meetings, and also the involvement of the investment advisers.

Fund valuation as at 31st March 2006

31.03.2005		31.03.2006
£'000s		£'000s
353,509	Fixed Interest Securities	302,010
995,288	Equities	1,664,724
862,332	Index-Linked Securities	-
436,754	Managed & Unitised Funds	1,046,637
111,328	Property Unit Trusts	130,284
43,449	Private Equity	106,420
-	Commercial paper	7,749
-	Purchased options	648
186,860	Cash and other	213,991
2,989,520	Total Net Assets	3,472,463

Investment costs

Costs were reviewed during the year and will increase significantly with the new investment mandates. More active and complex mandates demand higher fees. A structure of performance related fees has been introduced but investment return targets are set net of fees. Other costs of external services were reduced by some £60,000 year-on-year reflecting a greater in-house input.

New Mandates

Active Sub-fund

The existing Goldman Sachs (GSAM) global equities portfolio, with a bespoke benchmark and plus 1% performance target, which has exceeded target from inception, was retained as a core, lower risk, portfolio and increased by 50%.

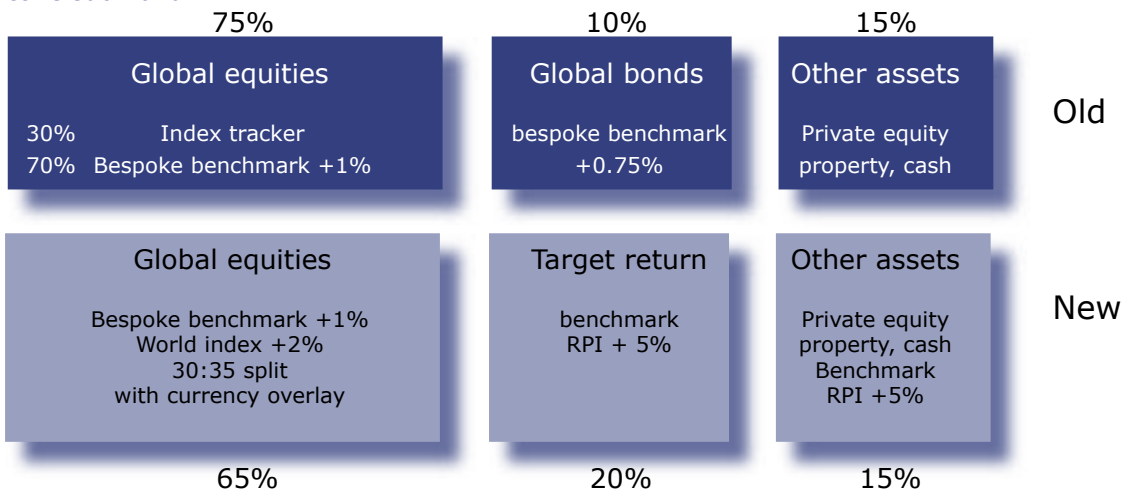
Two new global equities mandates of £300m each were established, with slightly more aggressive targets at global benchmark +2%. MFS and Newton were appointed to manage these portfolios.

To further develop our risk management, we appointed a currency manager (Record Currency Management) in relation to exposure to overseas currencies in the equity portfolios managed by the active equity managers. The currency manager will provide a hedge for 50% of this exposure and an active management brief to add extra return.

Two new mandates of £175m each using a target return approach were established, with the targets set at Retail Price Index (RPI) +5% and Merrill Lynch and UBS have been appointed to do that. This relatively new approach to investment matches our desire to achieve an investment return that reflected our index linked liabilities, and also provide a counterweight to more traditional equity mandates which move in line with equity benchmarks.

The Alternative Investment portfolio at 15% of the Active Sub-fund was left largely unchanged, with exposure to property, private equity and Private Finance Initiative (PFI). Investments within this portfolio will be managed by the Chairman, in conjunction with officers and advisers, and an overall benchmark of RPI plus 5% was set for performance monitoring purposes.

Active sub-Fund

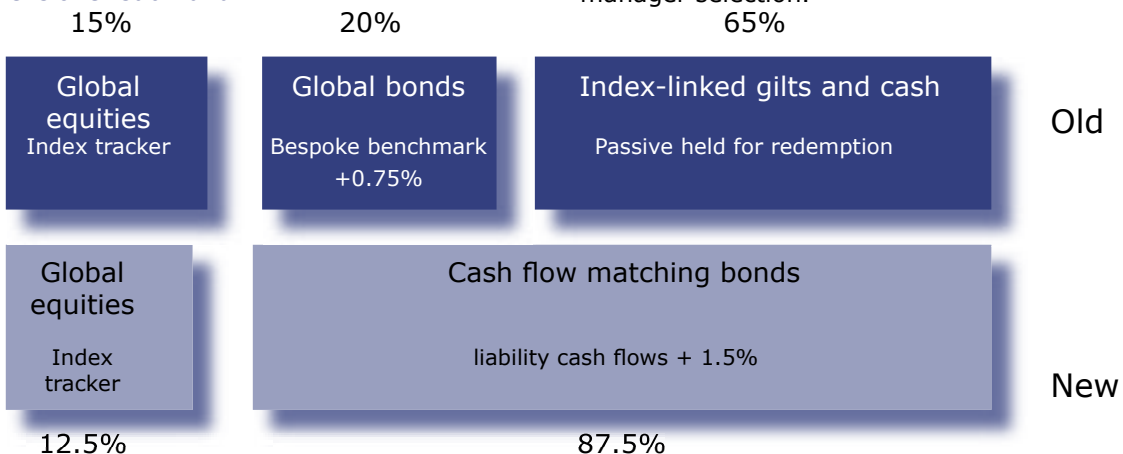


Pensioner Sub-fund

The equity mandate has been retained to diversify risk but has been reduced to 12.5% and will continue to be managed on a passive basis with Legal and General Investment Management (LGIM). We will review the options for enhanced index

tracking to lift returns without undue added risk. Three mandates, one of c£300m (ECM), and two of c£450m (Barclays Global Investors (BGI) and Insight), have been structured to arrive at an aggregate 1.5% outperformance. Again, a mix of investment styles has been an essential ingredient in manager selection.

Pensioner sub-Fund



Alternative Assets

The strategic policy aimed to diversify 15% (or currently some £300m) of the asset base of the Active sub-fund away from equities and into alternative assets continued during the year. Within what is an expanding asset class, the LPFA's investments are currently focussed on three key areas, Property (via Property Unit Trusts (PUTs)), Private Equity and the Private Finance Initiative. An investment in Commodities remains under active review.

Other assets portfolio

Valuations at 31 st March	2005	2006
Private equity		
Programme 1	9.2	22.3
Investment trusts	30.8	56.6
Other funds	0.5	1.0
Property Unit Trusts	111.3	130.3
Private Finance Initiative	3.8	11.8
Cash and other ⁽¹⁾	84.4	78.0
	240.0	300.0

⁽¹⁾ A specific allocation of cash to this portfolio within the Active sub-fund was made with effect from 1st January 2006

Property Unit Trusts (PUT's)

The £100m investment made in 5 major PUT's between September 2003 and June 2004 has now grown to a value of some £130m (a growth in net assets of some 14% pa). These trusts, which offer a far more diversified and cost effective and marketable means of holding property than could be achieved by physical direct property investment, provide exposure to actively managed portfolios of commercial, office and industrial property in the UK. Whilst returns over the next year will remain relatively attractive they are unlikely to match the very high levels achieved over the last two years. There are no current plans to increase exposure to this asset class, but some modest diversification into European property has recently been discussed.

Private Equity Funds

The first private equity programme which commenced in October 2003, with three fund of fund managers and a £125m commitment has been 20% drawn down so far. In April 2006, immediately following the year end, another similar programme was initiated. The two programmes differ slightly with regard to their geographic exposure (for example the new programme includes a modest exposure to Asia, whereas previously just North America and Europe) and also strategic focus (new programme has a somewhat reduced focus to buyouts but an increased exposure to venture and secondary funds).

To bridge the gap caused by the random timing of fund draw-downs and to maintain the exposure to the sector, investments in a small number of quoted investment trusts that specialise in private equity have been held over the last year or so. These have proven very successful. The strategy remains that these holdings will be reduced over time as the fund of funds called amount increases.

Private Finance Initiative

Exposure to this sector has been increased by increased calls on the two Limited Partner funds previously held and by an investment in a new London Stock Exchange listed vehicle, HSBC Infrastructure Co. Ltd which came to the market in March 2006.

Strategic asset allocation

The table below shows the asset allocations at the year end against the long term targets set as part of the new investment strategy.

To a large extent, the differences against target are driven by market valuations and the allocation of cash. The Board has decided not to apply a rigid re-allocation policy but to keep the position under regular review. There is a special policy meeting with the advisers in June and this will shape the debate for the away day.

	Policy Target	31.03 2006	Differ- -ence
Active sub-fund			
Global Equities	65%	63%	-2%
Target Return	20%	19%	-1%
Currency	0%	1%	1%
Alternative Assets	15%	12%	-3%
Cash	0%	5%	5%
	100%	100%	
Pensioner sub-fund			
Global Equities	12.5%	14.0%	1%
Cash Flow Matching	87.5%	83.0%	-5%
Cash	0.0%	3.0%	3%
	100.0%	100.0%	

Funding and investment strategies

With a funding deficit emerging for each Sub-fund from the 31st March 2004 actuarial valuation, considerable time was devoted developing a long term and viable funding strategy in consultation with the actuary, and consulting employers on the impacts and options.

The new investment strategy is closely linked to the liability profiles that have emerged from the valuation process and by the solvency position of individual employers. This has led to a longer term view of investment and the generation of returns related to liabilities and funding, rather than in relation to other funds or market indices. It was clear that investment returns needed to be increased whilst not further increasing risk unduly.

With a liabilities-based investment strategy being implemented for each of the sub-funds it was important that the Authority was able to monitor the change in the liabilities and the funding deficit to inform the decision-making process. A model was developed internally to achieve this and the funding status of the sub-funds is reported to the trustees each quarter.

This process complements the more formal six-monthly actuarial reports introduced from September 2005 for the Active Sub-fund as a means of communicating developing trends in funding to employing authorities.

Largest equity holdings at 31st March 2006

Shares in issue	£m
Royal Dutch Shell	36.8
Astrazenica	28.9
BHP Billiton	23.0
Old Mutual	19.5
BP	18.8
3I Group	18.1
BT Group	17.7
SVG Capital	17.6
Unilever	16.9
HBOS	15.5

Financial assumptions

	Mar 2004 % p.a. (1)	Mar 2006 % p.a. (2)
Investment Return /Discount Rate		
Active Sub-Fund	6.30%	5.77%
Pensioner Sub-Fund	6.20%	5.69%
Pay Increases		
	4.40%	4.54%
Price Inflation /Pension Increases		
	2.90%	2.70% (3)

- (1) As used in the valuation
 (2) Currently used for inter-valuation monitoring
 (3) RPI for September

Investment Performance

The custodian, JP Morgan Chase, now undertakes the measurement of investment performance of the sub-funds. This commenced in January 2006 and is based on the custodian's accounting data. The WM Company ceased providing this service at the end of December 2005.

The comparative returns over 1,3 and 10 year periods is set out in the table.

Performance summary as at 31st March 2006

	1 Year	3 Years	10 Years
Active sub-Fund	23.2	15.5	5.9
Benchmark	24.0	19.8	7.2
Pensioner sub-Fund	9.3	7.6	7.9
Benchmark	10.3	8.3	7.9
RPI (broadest measure)	2.4	2.7	2.6

It should be noted that the portfolio structures and benchmarks have changed significantly over the past 10 years with major changes implemented as part of the new investment strategy.

However, returns have been below expectation due to asset allocation and stock selection decisions being behind the market. This performance led, in part, to the review of management structures and return/risk profiles.

Over the longer term, investment returns have been ahead of inflation and broadly in line with actuarial assumptions.

The financial year returns for 2005-06 were heavily influenced by the transition to new mandates and this is expected to settle down in 2006-07 and for performance levels to reach targets.

Compliance Reporting

Manager accountability meetings

Meetings are held formally with all investment managers, on a quarterly basis. These meetings are conducted by the investment team for the purpose of analysing and reviewing the investment process by which the funds under management are managed as well as the progress being made against the objectives set out in the investment management agreement.

At these meetings a wide range of topics are discussed. These include any the changes in the management team, attribution analysis, relevant economic and political developments.

These meetings also provide a useful opportunity to directly convey any concerns that the Authority may have.

The outcome of these meetings, including a comprehensive statistical analysis, is presented to the Investment Strategy Committee. This process will be complemented by research and analysis by Analytics of trading activity by the equity managers related to expectations when appointed

Due to the size and complexity of the new mandates, and as a result of the relationship meetings described above, generic manager presentations to Committee will cease. Instead, the Committee will receive presentations on the operations of the mandates and on specific asset classes as a form of training. Managers will be called to account where they depart from the mandate requirements or underperform consistently.

Corporate governance

During the year under review, the LPFA voted in favour of 871 resolutions and against 589 resolutions and abstained on 53 resolutions for UK companies.

The Board re-appointed Manifest for a further 12 month term to June 2006 to provide a UK Research and Voting Service. This service consists of a platform that enables voting to be undertaken, meeting reports for all UK constituent holdings and voting reports. This contract has recently been extended for a further 12 months while current policy is reviewed.

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

The Authority, 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 membership of National Association of Pension Funds (NAPF) and Institutional Investors Group on Climate Change (IIGCC), the Authority 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. The Authority's policy in this respect was 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

Under the new investment strategy the securities lending programme has reduced in size with the transfer of the UK Index-linked gilts portfolio to external cash flow matching bond mandate investment managers.

The securities lending programme now consists of the Active Sub-Fund global equities mandates, which are managed on a segregated basis. The balance of the mandates are managed on a pooled fund basis in which LPFA is not an active owner.

All lending is undertaken by the custodian JP Morgan Chase on an indemnified basis and collateral is set at 105%. The proportion of current loan value to available portfolio value is about 5% or approx. £60m, and well within the requirements of the LGPS 1998 regulations which has a 35% upper limit.

Custody and banking

The existing global custodian, JP Morgan Chase, was re-appointed in 2004 for a three-year term following a comprehensive tender process and market review on considerably improved service terms to the Authority. Service delivery is monitored on a regular basis and quarterly meetings are held with the custodian. The Committee held an accountability meeting with the custodian during the year.

Transaction costs

All external managers comply with the IMA transaction cost disclosure code and report quarterly. The data is analysed by the Authority's in-house investment team and considered by the Committee.

Effective transaction cost analysis promotes transparency and accountability of the managers and is a strong incentive encouraging efficient trading decisions. This assists LPFA in understanding costs incurred by managers allowing informed decisions regarding the overall level of transaction costs and identification of areas of concern.

Whilst the ability to accurately measure transaction costs for equities portfolios is straightforward it is less straightforward for pooled fund vehicles, fixed income trading, foreign exchange and derivatives trading. Often informed estimate is needed.

Having this process in place has led to enhancements in the Authority's overall monitoring process through;

Familiarity and training

- ~ a greater understanding of the trading processes utilised by the investment managers, and
- ~ investment managers awareness that the trading strategy is actively monitored as part of the manager review process.

The introduction of unbundling of commissions through new regulations in 2006 will require further review and consideration.

Myners compliance and SIP

The central proposal of 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 were reviewed and revised by HM Treasury in 2004.

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 with all 10 principles.

The Authority supports the practice of regular training to ensure trustees are sufficiently familiar with the issues on which they are required to make decisions. Trustees attend training seminars, workshops and conferences provided by external providers, including the National Association of Pension Funds. Internally trustees have separate training sessions on specialist issues, and receive reports submitted by officers.

The investment review process provided the opportunity for familiarisation sessions on the new mandates and structures, and involved Members in manager selection and due diligence work. In particular, research was undertaken into the use of derivatives, their legality and application in the new structured mandates.

The advisers played a key role in this respect during the review process by explaining new investment approaches and providing feedback on actions and decisions. An annual investment report by the advisers will be made to the next Board away day planned for September 2006.

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



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