

# London Pensions Fund Authority

## Investment Report 2006-07





## Annual market review – year to 31st March 2007

Equity markets performed well during the year to end March 2007, supported by strong corporate profits and a generally sound economic background. Merger and acquisition activity provided further support driven, in the main, by private equity deals. There were two periods of sharp downward spikes, the first in May 2006, and another during the early months of 2007. The downturns reflected the many uncertainties, not just financial or economic, faced by investors. War in Lebanon, and a potential 'stand-off' between the US and Iran are just two examples of political issues that unsettled investors during the year. However, these have proved to be temporary blips against the underlying economic support for equity growth.

The MSCI world index of global equity markets returned 2.1%. However the UK outperformed the world index, the FTSE All-Share index returned 11.2% during the period. Small and mid cap stocks outperformed their larger counterparts by a significant margin, continuing a trend now extended to more than five years. The best performing sectors, relative to the All-Share index, were Utilities (+21.3%) and Consumer Services (+12.2%); the worst were Oil & Gas (-16.8%) and Healthcare (-11.2%). A notable feature during the year was the significant underperformance of the four largest stocks (Royal Dutch Shell, BP, HSBC and GlaxoSmithKline) which, in total, account for over 20% of the index by market size. A feature of the UK and global markets has been the amount of merger and acquisitions activity.

European (ex UK) equities returned 16.0% and North American equities returned 12.0%, in local currencies; Japanese equities advanced by a more modest 1.9% despite improving economic conditions. UK investors were adversely affected by currency movements, in particular, by Sterling appreciation against the US \$ and Japanese Yen. When translated into Sterling, North American gains turned negative, to -0.9%, and those of Japan to -9.9%. The best performing global sectors, relative to the FTSE All World index, were Utilities (+16.8%) and Telecoms (+13.4%); the worst were Technology (-10.3%) and Healthcare (-6.8%).

The economic background was generally positive with growth in the UK and Europe holding up well by international standards. In contrast, there was a distinct deceleration in the US, with the housing market the main area of concern. Whilst growth in Japan was strong by recent standards, deflation has not been resolutely defeated and domestic demand remains weak.

In March 2007, the Chancellor of the Exchequer presented his annual budget. The main points included a reduction in the basic rate of income tax along with the abolition of the lower 10% rate. Corporation tax was reduced for large, but not small, companies. The economic growth forecast for 2007 is between 2.75% and 3.25%, with inflation (CPI measure) forecast to fall to 2% later in the year, compared with 3.1% in March. The IMF has praised the overall state of the UK economy, but criticised the lack of restraint in government spending.

During the year short-term interest rates were increased in the UK, US and Euro-zone, with inflationary pressures cited as the underlying reason; subsequent economic data indicate that further increases are possible.

A key issue for equity markets in the months ahead will be investors' risk preference, which, in turn, is sensitive to a complex mix of economic and political forces.

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For and on behalf of Hymans Robertson LLP



## Introduction

The investment report for 2005-06 focused on the decision making process and the consequent implementation of a new investment strategy. This strategy was designed to address the underfunding apparent in the 2004 valuation and meet future liabilities, taking a prudent level of risk.

This year, the report discusses the strategy as well as its first full year of operation by reporting on the performance delivered, the governance of the fund and our developing environmental, social and corporate governance (ESG) policy.

## Funding and investment strategies

With a funding deficit emerging for each Sub-fund from the 31<sup>st</sup> 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 starting point for the new investment strategy was the liability profile of each of the two Sub Funds. In the case of the Active Sub Fund, the liabilities are very long term. It was concluded that the Sub Fund's objectives could be better achieved by seeking a higher rate of return. The increased risk that this might have entailed was eliminated by diversifying the sources of return (e.g. through the introduction of absolute return funds and a diversified approach to alternative investments) and by other specific risk reduction measures (e.g. by partial hedging of the overseas currency risk).

In the case of the Pensioner Sub Fund, a much more liability matched approach was necessary in order to minimise the likelihood of having to call on the Fund's guarantors for support some time in the future. Thus, for the bulk of the Fund's assets, managers were appointed with a brief of producing the specific cashflows required to pay the pensions. The Sub Fund does, however, need to generate additional returns to close the deficit. This is intended to be achieved by retaining a small exposure to equity markets and by requiring the three cashflow managers to use their skill to produce slightly higher cashflows than those needed to pay the pensions.

With a liabilities-based investment strategy being implemented for each of the sub-funds it is important that the Authority is 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.

Over the period to 31 March 2007, equity markets were strong. In addition, the Fund's managers, in aggregate, outperformed their benchmark and the currency hedging not only reduced risk but also added to the Fund's returns. It is expected that these favourable factors will have improved funding levels compared with those revealed at the last actuarial valuation in 2004. However, some of this good news will be offset by the costs associated with lower interest rates, higher inflationary expectations and the well publicised improvements in the UK's longevity. The results of the 2007 actuarial valuation will be included in the Annual Report next year.



## Investment strategy

The new investment strategy was implemented at the start of 2006 with the following structure:

### Active Sub-fund

Global equities	Target return	Other assets
30% Bespoke benchmark +1% 35% World index +2% with currency overlay  <b>65%</b>	Target RPI +5%  <b>20%</b>	Private equity, property, commodities Target RPI +5%  <b>15%</b>

The investment strategy was developed to ensure the funding deficit identified at the 2004 actuarial valuation is eliminated over the long-term. With the liabilities being of long duration it provided the framework for a strategy that could achieve a return well in excess of the liabilities. As such, a significant exposure was established to global equities markets, which is expected to deliver the best return over the long term. Global equity markets can be volatile though, so to manage this risk, a diversified portfolio was established including exposure to both target return funds and alternative assets.

By implementing a long-term investment strategy it is able to withstand periods of short-term volatility whilst still being able to meet its investment objective over the long-term.

The Active Sub-Fund manager roster consists of three global equity managers; Goldman Sachs (GSAM); Newton and MFS; two total return managers; UBS and BlackRock and one currency manager Record Currency Management. In addition, an alternative assets portfolio invested across a range of exposures in property, private equity and commodities managed by specialist managers and overseen by the board of trustees was established.

GSAM has a bespoke global equities benchmark with a +1%pa outperformance target and has been employed since 1999. Both Newton and MFS were appointed in 2006 and have the MSCI global equities index as a benchmark with a 2%pa outperformance target. These three managers were chosen, not only because they had strong performance and risk control records but also because have different styles of management. Combining the three managers further reduces the volatility of returns expected from the Sub-Fund.

We appointed Record Currency Management as the currency manager for two reasons. Firstly, in relation to exposure to overseas currencies in the equity portfolios managed by the active equity managers, Record provides a hedge for 50% of this exposure back into sterling. Given the liabilities of the fund are denominated in sterling, it enables the fund to invest in global equity markets whilst reducing the currency mismatch and hence the risk. Also Record have an active management brief to add extra return.

The total return funds were integrated into the investment strategy as a counterweight to the more traditional equity mandates that move broadly in line with global equity benchmarks. These funds have an unconstrained mandate allowing the fund managers to invest across a range of asset classes and achieve an investment return that reflects the Sub-Funds index-linked liabilities.



## Alternative Assets portfolio (£m)

Valuations at 31 <sup>st</sup> March	2006	2007
<b>Private Equity</b>		
Programme 1	22.3	45.8
Programme 2	Nil	10.1
Cleantech Venture	Nil	13.4
PE Investment trusts	56.6	72.8
Other funds	1.0	2.0
<b>Property</b>		
UK Property Unit Trusts	130.3	114.9
Infrastructure / PFI	11.8	24.1
Commodity funds	Nil	6.3
<b>Total</b>	<b>222.0</b>	<b>289.4</b>

The Alternative Investment portfolio constitutes 15% of the Active Sub-Fund's long-term strategic allocation and has exposure to property, private equity, infrastructure and commodities. The investment strategy has been developed over the past four years to achieve a diversified exposure to non-traditional assets both in the UK and globally. It has a performance target of RPI plus 5%pa.

Investments within this portfolio are actively managed by the board of trustees in conjunction with officers and advisers. New opportunities are reviewed and considered for inclusion in the portfolio on the basis of meeting strict criteria imposed.

Alternative Assets have seen dramatic growth both in interest and in investment by institutions over the last couple of years as they try and diversify their portfolios to reduce the risk of large equity positions. Our portfolio has increased in value from £222million to £289million over the year. This has been achieved by a mixture of increasing values and new money committed. The exception to this has been the exposure to UK property where we took advantage of strong performance to trim 20% of our holding. This investment has returned in excess of 18% pa in the last three years. Concerns over the prospects for UK property returns following this period of exceptional performance has led us to the decision to appoint a global property manager. We continue to believe that property is an excellent asset for the fund to hold but believe that better returns are available overseas. The appointment of our manager is expected in July 2007.

Within the private equity portfolio, cash continues to be drawn down in our existing programmes. Last May, we established a £50m portfolio of CleanTech European venture funds. CleanTech is a generic term used to embrace a diverse range of products, services and processes that are inherently designed to provide superior performances at lower costs and which greatly reduce or eliminate environmental impacts. These technologies span many industries from alternative forms of energy generation to water purification to materials recovery to micro-irrigation.

A holding in a forestry and timber company, Phaunos, initiates exposure to commodities for the fund.



## Pensioner Sub-fund

<b>Global Equities</b>  Index tracker  <b>12.5%</b>	<b>Cash flow matching bonds</b>  liability cash flows +1.5%  <b>87.5%</b>
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The core investment strategy is based around the management of risk relative to the Sub-Funds liabilities ensuring greater control over the funding position. With limited opportunity to source increased employer contributions it is dependant on the Sub-Funds investment performance to eliminate the funding deficit over the long-term.

This required a trade-off between hedging the risk of the liabilities and investing in return-seeking assets. As the Sub-FUND was underfunded there were insufficient assets to fully hedge all the liabilities.

A 'liabilities-driven' approach was implemented. In particular, three fund managers were appointed to hedge specific components of the liabilities; ECM (fixed liabilities), Barclays Global Investors and Insight Investment (inflation-linked liabilities). In addition, these managers were mandated to actively invest across global fixed interest markets to achieve an aggregate 1.5%pa outperformance. A mix of investment styles was an essential ingredient in the manager selection process.

Importantly, an exposure to equities was retained with the expectation of generating excess performance above that of the liabilities and to diversify risk. This mandate is managed on a passive basis by Legal and General Investment Management.

## Investment Performance

Performance summary as at 31st March 2007

	1	3	10
	Year	Years	Years
Active sub-Fund	7.6	13.6	5.8
Benchmark	4.8	13.0	6.5
Pensioner sub-Fund	2.3	5.9	7.2
Benchmark	1.8	6.0	7.1
Headline RPI	4.8	3.5	2.8

The past year has been a successful one for the fund. The decision to hold global equities and no bonds in the Active sub-fund has reaped immediate rewards as has the decision to retain global equity exposure in the Pensioner sub-Fund as well as the liability driven portfolio.

Longer term performance is satisfactory despite portfolio structures and benchmarks changing significantly over the past 10 years, with major changes implemented in 2006. Long term investment returns have been ahead of inflation and broadly in line with actuarial assumptions.



## Fund Valuation and Asset allocation

The table below shows the valuation and asset allocation at the year end against the long term benchmark

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.

### Active Sub-Fund at 31 March 2007

	Benchmark	Dist'n	Fund
	%	%	£m
Global Equities	65	62	1,422
Target Return	20	22	511
Currency	0	0	12
Alternative Assets	15	13	290
Cash	0	3	49
	<b>100</b>	<b>100</b>	<b>2,284</b>

### Pensioner Sub-Fund at 31 March 2007

	Benchmark	Dist'n	Fund
	%	%	£m
Global Equities	12.5	14	191
Cash Flow Matching	87.5	84	1,102
Cash	0	2	22
	<b>100</b>	<b>100</b>	<b>1,315</b>

**Total Scheme Assets** **3,599**



## Review of performance on decisions and actions

The Investment Committee met six times during the year and considered 34 reports covering strategy, monitoring, responsible investment and compliance reports covering treasury management, corporate governance, securities lending, transaction cost disclosure, custody, performance measurement, the website and Freedom of Information.

### Evaluate current in house arrangements

Responsibility for the in-house investment team was assigned directly to the new post of investment director. The post was filled on 19<sup>th</sup> March 2007.

### Alternative assets

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

### US shareholder litigation

All litigation action is researched and reported to the investment committee ~ see the Compliance reporting section next in this report.

### Manifest UK voting service

Contract reviewed and extended for one year to June 2007.

### Review role of independent advisers

Review completed and contracts extended for two years to February 2009.

### Statement of Investment Principles

The SIP is generally reviewed and revised to reflect changes in the investment strategy.

### Transaction cost disclosure

Monitoring arrangement provided by Analytics were terminated in January 2007. We are working with the managers to develop a template for reporting of transaction costs.

### Freedom of Information

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

### Investment communications

The corporate website provides a regular update of standardised monitoring information. Employer Forums were used to communicate changes in investment strategy. External newsletters produced for employers and members contain investment updates.

### Build investment manager relationships

Quarterly meetings are held with each of the managers and the outcomes are reported to the investment committee ~ see the Compliance reporting section next in this report.

### Compliance processes with managers

All areas reviewed and developed through the monitoring meetings. LPFA policies on responsible investment, voting and procurement are embedded in the investment management agreements.

### LCC stock redemption

Profit of £20m on the sale of LCC stock in 2006 was transferred to the Pensioner Sub-Fund in May 2007. War Loan has been purchased to match the remaining liability of unredeemed stock.

## Compliance Reporting

### Manager accountability meetings

Meetings are held 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 Scheme's assets are managed as well as the progress being made by the managers against the objectives set out in their respective investment management agreements.

These meetings cover a wide range of topics, including investment performance compared to stated objectives, changes in the management team, performance attribution analysis and 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 analysis, is presented to the Investment Committee.



Due to the size and complexity of the mandates the Investment Committee receive presentations on the operations of the mandates and on specific asset classes as a part of a formal training program. Managers will be called to account where they depart from the mandate requirements or underperform consistently.

#### Corporate governance

The Board re-appointed Manifest for a further 12 month term to June 2007 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.

During the year under review, the LPFA voted in favour of 394 resolutions and against 377 resolutions and abstained on 89 resolutions for UK companies.

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 the 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 is published in its Statement of Investment Principles and incorporates the responsibilities of the global equities investment managers.

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

The securities lending programme is undertaken exclusively by the custodian, JP Morgan, on an indemnified basis with collateral set at 105% of lending value. As at 31<sup>st</sup> March 2007 the amount of securities on loan was £53m, approximately

4% of the lendable portfolio value. This was well within the requirements of the LGPS 1998 regulations which have an upper limit of 35%.

The securities lending programme incorporates the Active Sub-Fund (i) global equities mandates, which are managed on a segregated basis (ii) the Blackrock segregated UK equities fund and (iii) the listed Alternative Assets. The remaining portfolios are managed on a pooled fund basis in which LPFA is not the direct owner of the underlying stock.

#### Custody and banking

JP Morgan was re-appointed in 2006 as global custodian to the Authority on considerably improved service terms. Service delivery is monitored on a regular basis and quarterly review meetings are held with the custodian. JP Morgan will also provide a private equity administrative service in future.

#### 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.



## Responsible investing

As a responsible investor LPFA incorporates environmental, social and governance (ESG) issues into its investment analysis and ownership activities on the understanding that these issues have a material impact on the long term return of investments. To emphasise this the Authority has adopted a new strategic objective ~ "To develop our investment options within the context of an ethical and sustainable investment strategy".

Over the next few months officers will be developing a framework around this objective and identifying key outcomes and indicators to monitor progress. There can be no timetable set for the delivery of this objective however and there can be no quick fix; milestones will be set and regular reports will be submitted to the Investment Committee and to stakeholders via this annual report and newsletters. The Authority's Statement of Investment Principles will be amended and re-published to reflect the new objective.

We recognise that we do not have the resources to be fully active or to engage widely in relation to our own investment portfolios. Accordingly, we instruct investment managers to progressively develop and implement engagement policies on our behalf and support and participate in collaborative initiatives to develop engagement with companies on ESG issues.

Recently we have delegated our UK, and global where practical, voting activity, to Fund managers in accordance with agreed criteria. Regular meetings with all fund managers include discussion on their own responsible investing policies and the optimum means of engaging with companies.

The LPFA continues to participate in and supports collaborative projects such as signing up to the UN Principles for Responsible Investing (UNPRI) and participation in networks and specialist knowledge sharing opportunities such as are provided by the Institutional Investors Group on Climate Change, the International Forum for Active Shareowners, the Marathon Club, the Enhanced Analytics Initiative, the National Association of Pension Funds, and the Local Authority Pension Fund Forum (LAPFF). The LPFA's Chief Executive is currently the LAPFF's representative on the UK Social Investment Forum's Sustainable Pensions Project. He is also leading on the design of a responsible investment self assessment tool on behalf of the LAPFF. The LPFA encourages all its advisers, Fund managers and other Funds to participate also.

The Authority is aware of its responsibilities to Fund employers and members and other stakeholders and will be consulting widely on our responsible investment activity over the coming year.

## Familiarity and training

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 advisers play a key role in this respect 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 2007.



### Largest equity holdings at 31<sup>st</sup> March 2007

Company	£m	Country
Royal Dutch Shell	37.8	UK
3I	35.7	UK
Royal Bank Of	30.8	UK
Astrazenica	27.0	UK
Unilever	23.4	UK
Vodafone	23.0	UK
Anglo American	22.0	UK
Nestle	20.5	Switzerland
Royal & Sun Alliance	18.4	UK
Roche	16.8	Switzerland
BP	15.8	UK
HBOS	15.4	UK
Tesco	15.2	UK
Morrisons	14.6	UK
SVG Capital	14.5	UK
GlaxoSmithKline	13.8	UK
E.ON	13.0	Germany
Exxon Mobil	12.8	USA
Cisco Systems	12.7	USA
Vivendi	12.5	France

LPFA's Investment Report forms part of the five document Annual Report and Accounts and should be read in conjunction with the following reports in order to build a full picture of LPFA's performance:

Performance Report, Governance Report, Financial Report, Annual Report

Copies of these documents can be obtained by contacting the Marketing and Communications Team or can be downloaded from the our website [www.lpfa.org.uk](http://www.lpfa.org.uk)

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