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investment report 2007-08

part of the pension fund annual report

Annual Market Review to 31 March 2008

The year to 31 March 2008 will be remembered for the global 'credit-crunch' and perhaps, more poignantly in the UK, for the spectacle of anxious depositors queuing outside Northern Rock to withdraw their savings, the first run on a UK bank for over a century.

Global equity markets suffered their first sharp falls during July and early August 2007, as investor confidence evaporated on concerns over banks' lending practices. What appeared, initially, to be a local problem, restricted to a few sub-prime mortgage lenders in the US, soon spread across global credit markets. A curious feature of events was that, whilst the existence of a problem was undisputed, few recognised the magnitude of the potential losses and, worse, where the losses lay.

As the crisis unfolded and extended beyond the US, inter-bank lending became more expensive. Banks became increasingly reluctant to lend to each other, thus compounding the difficulties faced by financial institutions. Banks in all major financial centres suffered significant losses and write-downs; for a small number the pressures were such that survival was not possible.

The returns from equity markets were mixed, but generally negative (see table), with a stark contrast between the performance of developed and emerging markets. The impact of Sterling's sharp depreciation against the Yen and Euro is evident from the differences between local currency and Sterling returns.

United Kingdom	-7.7	-7.7
North America	-4.2	-4.8
Europe (ex UK)	-12.9	+2.8
Japan	-27.7	-15.4
Pacific Basin (ex Japan)	+6.6	+9.0
Emerging Markets	N/A	+19.6

The best performing sectors in a global context (relative to the 'All World' Index) were Basic Materials (+29.5%) and Oil & Gas (+21.2%). This reflects the seemingly insatiable demand for commodities and, in particular, the increasing needs of China and other emerging economies. The worst performing sectors were Financials (-15.3%) and Consumer Services (-11.1%).

Government bond prices rose (yields fell) over the year, as investors sought the relative safety of this asset class. In contrast, and reflecting the developing crisis in credit markets, corporate debt performed poorly; investors demanded a sharp increase in credit spreads to offset the additional risk and lack of liquidity now attached to this type of investment. Property (UK) returned -10.7% over the year.

In response to the turmoil in credit markets, and to the liquidity crisis in particular, central banks in the UK, the US and Europe provided direct assistance and support to 'distressed' banks. In addition, short-term interest rates in the US were cut aggressively, in six stages, from 5.25% to 2.25% between September 2007 and March 2008. The US suffered its own 'Northern Rock' experience when investment bank Bear Stearns collapsed under the pressure of its financial position in March 2008.

In the UK, the Bank of England increased short-term interest rates in May and July 2007, from 5.25% to 5.75%: at this time inflationary concerns were paramount. As the credit crisis developed, official short-term interest rates were cut, to 5.5% in December 2007 and again, to 5.25% in February 2008. Despite this accommodative stance, inter-bank lending rates remained high relative to official short-term rates. For example, at the end of March, three month interbank rates were around 6.00% while official short term interest rates were 5.25%.

Prepared by:- John Dickson, Partner, May 2008 For and on behalf of Hymans Robertson LLP

Introduction

This year's report discusses the development of our investment strategy in the light of the new information available from the 2007 valuation. It also reports on the performance delivered, the governance of the fund and our developing environmental, social and corporate governance (ESG) policy. A summary of the economic context in which we have operated, provided by our Actuary Hymans Robertson, is attached.

Funding and investment strategies

With a funding deficit emerging for each Sub-fund from the 31st March 2004 actuarial valuation, considerable time was devoted to developing a long term and viable funding strategy in consultation with the actuary, and consulting employers on the impacts and options available. The 2007 valuation enabled the first detailed analysis of how well the strategy implemented as a result of those discussions was working, albeit over a short time horizon. In summary, the results of the 2007 valuation show an improvement in the funding level of the Active Sub-Fund, from 74% to 82%, largely due to the strength in global equity markets which is the foundation of the investment strategy in the Active Sub-Fund, but a deterioration in the funding level of the Pensioner Sub-Fund, from 91.5% to 86% principally caused by the adoption of new mortality assumptions which reflect the increasing life spans of our members. In both cases the investment strategy had produced returns within the boundaries that we had expected. In fact, those generated within the Active Sub-Fund were substantially ahead of our long term expectations over the short period March 2004 to March 2007.

The starting point for the investment strategy is always 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 in 2004 and reaffirmed in 2007 that the Sub Fund's objective of achieving 100% funding over 20 years is appropriate. The expected risk and return of the investment strategy was set in the light of this. Global equities remain our favoured long term asset and diversification is provided by investment in target return funds, private equity, property, infrastructure and commodities. This diversification provides attractive returns, but also substantial risk reduction benefits. After consideration of the 2007 valuation results, and with the benefit of observing the first two years of the new strategy in action, it was decided to make no major changes. Instead there have been some minor modifications made to allocations which is detailed below. The mismatch of global assets and sterling liabilities continues to be reduced by the imposition of a hedge back into sterling equal in size to 50% of the global equity exposure.

In the case of the Pensioner Sub Fund, a liability matched approach was chosen for the majority of the Fund's assets in 2004. Managers were appointed with a brief of producing the specific annual cashflows required to pay the pensions. However, the Sub-Fund did need to generate additional returns to close the deficit. This was to be achieved by retaining a small exposure to equity markets where we expect a higher return and also by requiring the three cashflow managers to use their skill to produce slightly higher cashflows than those needed simply to pay the pensions. As mentioned above, despite this strategy delivering expected returns, the funding gap of the Pensioners Sub-Fund has increased due largely to improving longevity. A Recovery Plan has been established to close this gap. The deficits are planned to be recovered over a 22 year period by charging an appropriate levy to each London Borough commencing April 2009. No change is to be made to the existing investment strategy at the current time.

Investment Strategy and Governance of Investment Decisions

The investment strategy and governance of investment decisions was reviewed and agreed by the Board on the first of April 2008. The allocation ranges below were adopted.

Active Sub-fund

Asset Class	Minimum	Target	Maximum
	%	%	%
Global Equities	45	55	65
Private Equity	0	5	7.5
Target Return	15	20	25
Diversifying Assets	15	20	25

The investment strategy was developed with an objective to ensure the funding deficit is eliminated over 20 years. The greatest exposure to global equities markets is retained which is expected to deliver the best return over the long term. Global equity markets can be volatile though, so to manage this risk and to take advantage of the illiquidity premium that exists in some classes, exposure to diversifying assets has been increased from 15% to 20%.

The Board has delegated the responsibility of asset allocation at sub-asset class level to the Investment Committee. The table below details their decisions.

Asset Class	Minimum	Target	Maximum
	%	%	%
Global Equities	**45**	**55**	**65**
MFS (active)	15	17.5	20
Newton (active)	15	17.5	20
Legal&General (passive)	10	15	30
Satellite (quoted)	0	5	7.5
Private Equity	**0**	**5**	**7.5**
Target Return	**15**	**20**	**25**
BlackRock	7.5	10	12.5
UBS	7.5	10	12.5
Diversifying Assets	**15**	**20**	**25**
Global Property	5	7	10
Commodities	0	3	5
Infrastructure	0	5	7.5
Opportunistic (including Hedge Funds)	0	5	7.5
Investible Cash	**0**	**0**	**5**
Currency			
Hedging		50% of quoted overseas equity exposure	
Active Overlay			
2 complementary mandates		£1 billion total	

The satellite and opportunistic funds have been established to take advantage of good ideas that may present themselves to add return to the funds, but where we do not want them to become core managers/ideas for the portfolio. The difference between the two is that the satellite will be comprised of quoted ideas and the opportunity fund of ideas within diversifying assets. It is envisaged that investment will not be made for less than £25m but anything above £50m would have to be approved by Investment Committee. Below £50m the Investment Director in conjunction with the Chairman and Chief Executive can take the decision. These funds are an innovation for 2008, and reflect the impact of the investment we have made in our in house resources.

Currently, the Active Sub-Fund manager roster consists of three global equity managers; Legal & General; Newton and MFS; two total return managers; UBS and BlackRock and one currency manager Record Currency Management. In addition, the diversified assets portfolio consists of one global property manager ING, infrastructure, and commodities. All of these plus private equity are managed by specialist managers and overseen by the Investment Committee.

Global Equity
There is one change of manager this year, Goldman Sachs has been replaced by Legal & General. We were worried by Goldman Sachs lack of adequate explanation for their continuing and consistent underperformance of their benchmark and decided to replace them with Legal & General passive funds. Goldman's had managed money for us since 1999 and had performed well until some two years ago.
Both Newton and MFS were appointed in late 2005 and have the MSCI World global equities index as a benchmark with a 2%pa outperformance target.

Three managers have been retained not only because they have strong performance and risk control records, but also because have they have different styles of management. Combining the three managers further reduces the volatility of returns expected from the Sub-Fund.

Private Equity
For the first time, private equity has been separated out from the diversifying assets class in acknowledgment that the returns from private equity are most closely correlated to those of quoted equity. A separate target and range has been established. The fund is invested in three private equity fund of fund managers, namely Pantheon; LGT and Harbourvest. We also have holdings in quoted private equity investment trusts, these ensure immediate proxy exposure to private equity. These quoted holdings are sold to balance the drawdown of committed capital by the fund managers.

Total Return
The total return funds stay in the investment strategy as a counterweight to the more traditional equity mandates that are targeted to move 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-Fund's inflation-linked liabilities.

Diversifying Assets
As heralded last year, we appointed a global property manager, ING, late last summer. We are in the process of transitioning our old portfolio of UK property unit trusts and cash into a global fund of funds investing in direct and listed property in Europe, North America and Asia. In accordance with our Environmental, Social and Governance (ESG) policy, one of the criteria used to score and hence determine the most suitable property manager was the attention they paid to environmental issues when involved in constructing/investing in property. ING have good credentials in this area.
The amount invested in infrastructure and commodities will increase in line with the new investment ranges. Our preferred route will be to build a diversified portfolio in both areas again using specialist fund managers. Infrastructure will be split between, economic, social and environmental infrastructure as well as by manager and geography. In commodities we will diversify by type and style of management.

Currency
Record Currency Management as the currency manager has two tasks to perform for us. 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 has an active management brief to add extra return. During 2008 we will investigate the addition of another currency manager who will take half of the money that Record have for active management as a risk reduction exercise.

Pensioner Sub-fund

Global Equities	Cash flow matching bonds
Index tracker	liability cash flows +1.5%
12.5%	**87.5%**

As mentioned above, there is no change to this strategy from the initial implementation in late 2005. The core investment strategy is based around the management of risk relative to the Sub-Funds liabilities ensuring greater control over the funding position. This requires 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.

The liabilities-driven approach is implemented through three fund managers who 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.

Fund Valuation and Asset Allocation @ 31st March 2008

Active Sub - Fund

The table below shows the valuation and asset allocation at the year end against the long term benchmark that applied on 31st March 2008(old benchmark). It is obvious that on the 31st March we were fully aware of the discussions at the Investment Committee in February that led to the recommendations for change passed by the Board on 1st April. The table reflects both benchmarks.

Active Sub-Fund at 31 March 2008				
	Old Benchmark	New* Benchmark Target	Fund	
			Distribution	£m
	%	%	%	
Global Equities	65	55	60	1,403
Target Return	20	20	20	448
Alternative Assets	15	25	18	417
Net Cash	0	0	2	53
	100		**100**	**2,321**

*Effective from 1st April 2008.

Pensioner Sub – Fund

As mentioned above, there have been no changes to the Pensioner Sub- Fund benchmark. The table below illustrates the asset allocation.

	Benchmark	Fund	
		Distribution	£m
	%	%	
Global Equities	12.5	13	159
Cash Flow Matching	87.5	85	1,092
Cash	0	2	26
	100	**100**	**1,277**

Total Scheme Assets @ 31st March 2008 £3.6 billion

Details of largest holdings as at 31 March 2008
Active Sub - Fund

The Fund holds equities either in segregated funds (where we are the owners of the shares in question) or in pooled funds (where we own units in the pooled fund rather than the underlying equity shares per se). Fund Managers hold equity assets as follows:

- Legal and General – pooled funds covering the FTSE world index of 2915 stocks, with separate funds for UK, Europe, North America, Japan and Asia Pacific.
- MFS – segregated fund with an average of 95 stocks across all world markets.
- Newton - segregated fund with an average of 120 stocks across all world markets.
- BlackRock – segregated fund with an average of 50 UK equity holdings plus other global pooled fund holdings.
- UBS – pooled fund across all world markets.

Property investments and some alternative investments are also held in pooled funds.

The ten largest holdings in the Active Sub-Fund are detailed in the table below, all are pooled vehicles.

Fund	£ in million	%
Legal & General Pooled UK Equity Index Fund	286	12.3
UBS Target Return Pooled Fund	219	9.4
Legal & General Pooled North America Index Fund	144	6.2
Legal & General Pooled European Index Fund	93	4.0
ING European Property Pooled Fund	67	2.9
BlackRock Pooled Cash Fund	43	1.8
Legal & General Pooled Asia Pacific Ex-Jap Index Fund	31	1.3
RREEF UK Property Pooled Fund	29	1.2
Legal & General Pooled Japan Index Fund	27	1.2
Trillium Private Partnership Pooled Infrastructure Fund	25	1.1

As can be seen, our investments in pooled vehicles are bigger than individual equity holdings held in segregated funds. As at 31 March 2008, our only directly held equity investments that comprise more than 0.25% of the active fund are as follows.

Largest directly held equity investments

Equity	£ in million	%
Nestle	25	1.07
Roche	17	0.75
Impax Environmental Markets	17	0.73
Phaunos Timber Fund	15	0.66
HSBC Infrastructure	12	0.51
E.ON	12	0.51
LVMH - Louis Vuitton Moet-Hennessy	12	0.49
SVG Capital	10	0.44
Johnson & Johnson	10	0.41

Largest directly held equity investments (continued)

Equity	£ in million	%
3i Group	10	0.41
Electra	10	0.41
Reckitt Benckiser	9	0.40
Suez	9	0.39
Jardine Matheson	9	0.38
Heineken	9	0.38
Bayer	9	0.38
StatoilHydro	9	0.37
Standard Chartered	9	0.37
Nike	8	0.36
British American Tobacco	8	0.36
Vodafone	8	0.36
GlaxoSmithkline	8	0.35
Candover	8	0.35
Canon	8	0.34
Linde	8	0.34
Kao	8	0.34
Diageo	8	0.33
Millicom International Cellular	8	0.33
Schneider Electric	7	0.32
Total	7	0.31
Bank of New York	7	0.31
Bangkok Bank	7	0.30
Tesco	7	0.30
3M	7	0.30
Pantheon International	7	0.30
General Mills	7	0.30
State Street	7	0.29
Babcock & Brown	7	0.29
Unilever	7	0.29
BAE	6	0.28
Merck	6	0.28
TNT	6	0.27
Telefonica	6	0.26
American Express	6	0.26
Givaudan	6	0.26
Air Liquide	6	0.26
United Parcel Service	6	0.26
Japan Tobacco	6	0.25
Exxon	6	0.25
Petroleo Brasileiro	6	0.25
BHP Billiton	6	0.25
Deutsche Boerse	6	0.25

Pensioner Sub-Fund

The Pensioner Sub-Fund holds three liability matching funds with Insight, BGI and ECM which comprises 87.5% of the fund.

Investment Performance

Annualised Performance returns as at 31 March 2008			
	1	3	10
	Year	Year	Year
Active sub-fund	-2.11	9.05	3.59
Benchmark	-0.93	8.76	4.15
Pensioner sub-fund	3.84	5.08	5.89
Benchmark	8.88	7.35	6.39
Headline RPI	3.80	2.40	2.10

The last year

The past year has been disappointing for the active sub-fund, global equities have not performed well and so it has suffered. As mentioned in many previous reports, equity returns are volatile and so short term periods of underperformance are to be expected. In fact the benefit of diversification is illustrated by these numbers as many global equity markets were down in excess of 5%. In addition poor short term performance from our currency manager and one of our target return managers, UBS, tarnished the excellent performance achieved by our two active global equity managers, Newton and MFS. As mentioned earlier Goldman Sachs continued lack of adequate explanation of their underperformance resulted in them being replaced during the year, but their performance has also depressed returns.
The pensioner sub-fund has had a better year in that returns were positive, but the underperformance of the benchmark is largely due to our European credit manager ECM who despite not holding anything that has defaulted during the credit crisis has suffered severe markdowns across the entire portfolio. We expect to recover much of this performance in the medium term.

Longer term performance

In the active sub-fund performance over three years shows the benefit of stronger equity markets and the movement to the new strategy. Despite ten year investment returns well ahead of inflation, persistence of sub 5% returns would have put a strain on achieving the sub-fund's objectives which is further support for the strategy shift.

Responsible investing

One of the LPFA's five strategic objectives is 'to develop our investment policy within the context of an ethical and sustainable framework'.

As a responsible investor LPFA aims to incorporate environmental, social and governance (ESG) issues into its investment policies and ownership activities on the understanding that these issues have a material impact on the long term return of investments. Realising the importance of this area the Board has agreed the appointment of an additional member of the investment team who will be responsible for driving our agenda forward on ESG issues. We hope to have the appointment made by September 2008.

Currently, we instruct our 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. We have initiated annual meetings dedicated to discussing only ESG issues with our fund managers. These are in addition to the more regular manager accountability meetings. The Investment Committee considers the engagement report from all of our fund managers quarterly.

We have delegated our global voting to our fund managers and we continue to develop our policy and practice in this area. The Investment Committee consider an exceptions report compiled from voting data supplied by our fund managers quarterly. In this case exceptions are defined as votes cast against management. During the year under review, the LPFA voted in favour of 3,133 resolutions and against 989 resolutions and abstained on 226 resolutions at company meetings.

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 designed a responsible investment self assessment tool on behalf of the LAPFF which has been disseminated this year and has been well received. The LPFA's Chief Executive delivered an address on ESG investment at the NAPF Investment conference in Edinburgh this year.

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.

Governance Reporting

Investment Committee Meetings

The Investment Committee met five times during the year and on four occasions considered reports on investment strategy, performance, monitoring, responsible investment and compliance reports covering corporate governance, securities lending, transaction cost disclosure and custody. There was an additional meeting in February 2008 focussing solely on the investment strategy for the Active Sub – Fund.

Manager accountability meetings

Meetings are held with all investment managers on a regular 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.

Class Actions

A US legal firm, Coughlin, Stoia, Geller, Rudman 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"). All litigation action is reported to the investment committee.

Securities lending

The securities lending programme is undertaken exclusively by the custodian, JP Morgan, on an indemnified basis with collateral set at 107% of lending value. As at 31st March 2008 the amount of securities on loan was £64m, approximately 7% 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 now provides us with a private equity administrative service.

SIP

The SIP will be reviewed and updated to reflect the changes in the investment strategy and governance by September 2008.

Myners Compliance

LPFA complies fully with all 10 Myners principles.

Review role of independent advisers

A review will be undertaken in advance of the current contracts expiring in February 2009.

Investment communications

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

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.

For additional information relating to LPFA's investment activities please contact:

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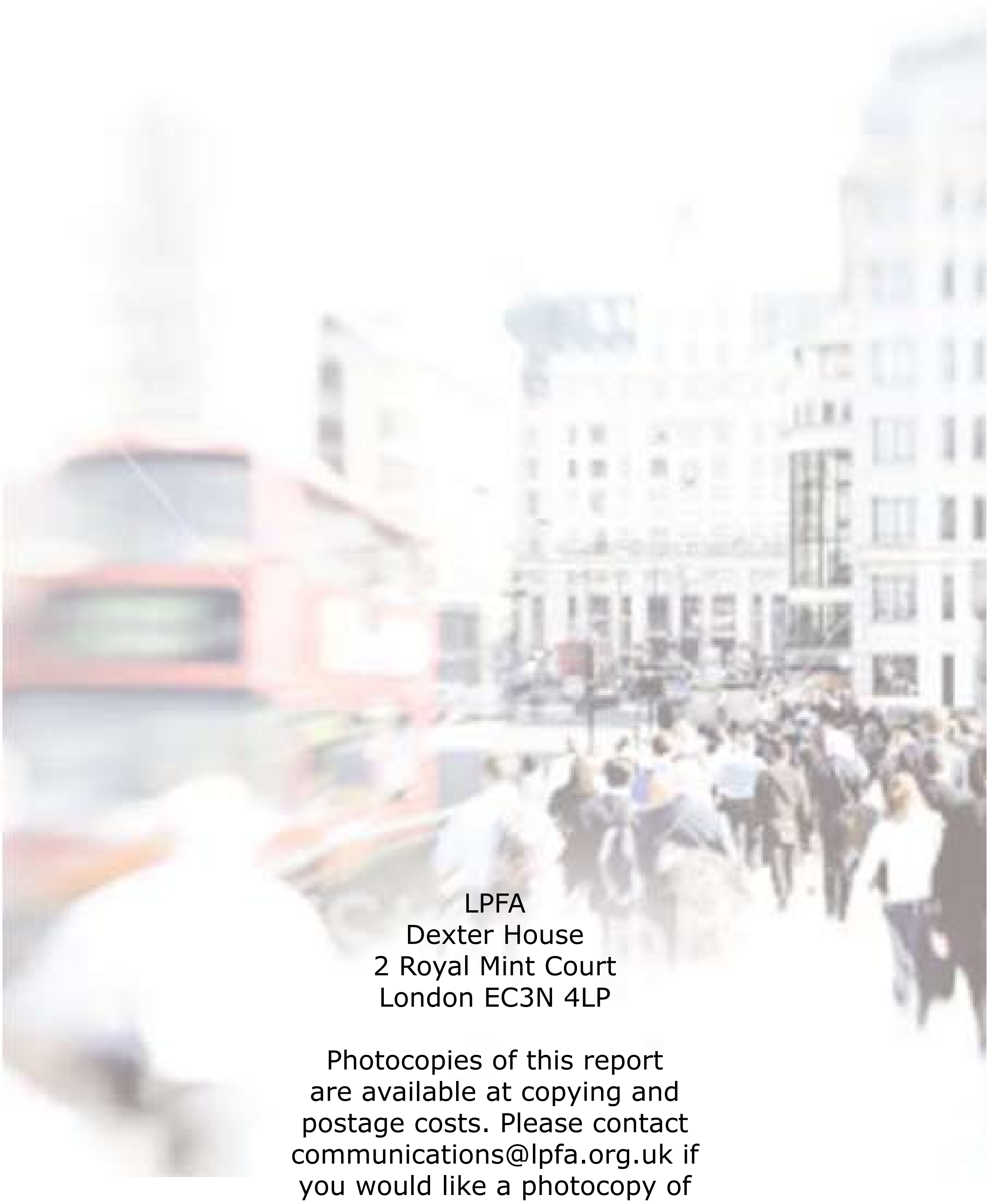

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