Bath & North East Somerset Council

Democratic Services
Riverside, Temple Street, Keynsham, Bristol BS31 1LA
Telephone: (01225) 477000 *main switchboard*
Direct Lines - Tel: Fax: 01225 394439
Web-site - http://www.bathnes.gov.uk

Your ref:
Our ref:
Date: 9 September 2010
E-mail: Democratic_Services@bathnes.gov.uk

To: All Members of the Avon Pension Fund Committee - Investment Panel

Councillor David Bellotti (Chair), Councillor Gordon Wood, Ann Berresford, Councillor Mary Blatchford, Bill Marshall and Councillor Gabriel Batt

Chief Executive and other appropriate officers
Press and Public

Dear Member

Avon Pension Fund Committee - Investment Panel: Thursday, 16th September, 2010

You are invited to attend a meeting of the **Avon Pension Fund Committee - Investment Panel**, to be held on **Thursday, 16th September, 2010** at **2.00 pm** in the **Avon Room - Fry Club and Conference Centre.**

The agenda is set out overleaf.

Yours sincerely

Sean O'Neill
for Chief Executive

If you need to access this agenda or any of the supporting reports in an alternative accessible format please contact Democratic Services or the relevant report author whose details are listed at the end of each report.

This Agenda and all accompanying reports are printed on recycled paper

NOTES:

1. **Inspection of Papers:** Any person wishing to inspect minutes, reports, or a list of the background papers relating to any item on this Agenda should contact Sean O'Neill who is available by telephoning Bath or by calling at the Riverside Offices Keynsham (during normal office hours).

2. **Public Speaking at Meetings:** The Council has a scheme to encourage the public to make their views known at meetings. They may make a statement relevant to what the meeting has power to do. They may also present a petition or a deputation on behalf of a group. Advance notice is required not less than two full working days before the meeting (this means that for meetings held on Wednesdays notice must be received in Democratic Services by 4.30pm the previous Friday)

   The public may also ask a question to which a written answer will be given. Questions must be submitted in writing to Democratic Services at least two full working days in advance of the meeting (this means that for meetings held on Wednesdays, notice must be received in Democratic Services by 4.30pm the previous Friday). If an answer cannot be prepared in time for the meeting it will be sent out within five days afterwards. Further details of the scheme can be obtained by contacting Sean O'Neill as above.

3. **Details of Decisions taken at this meeting** can be found in the minutes which will be published as soon as possible after the meeting, and also circulated with the agenda for the next meeting. In the meantime details can be obtained by contacting Sean O'Neill as above.

   Appendices to reports are available for inspection as follows:-

   Public Access points - Riverside - Keynsham, Guildhall - Bath, Hollies - Midsomer Norton, and Bath Central, Keynsham and Midsomer Norton public libraries.

   For Councillors and Officers papers may be inspected via Political Group Research Assistants and Group Rooms/Members' Rooms.

4. **Attendance Register:** Members should sign the Register which will be circulated at the meeting.

5. THE APPENDED SUPPORTING DOCUMENTS ARE IDENTIFIED BY AGENDA ITEM NUMBER.

6. **Emergency Evacuation Procedure**

   When the continuous alarm sounds, you must evacuate the building by one of the designated exits and proceed to the named assembly point. The designated exits are sign-posted.

   Arrangements are in place for the safe evacuation of disabled people.

Avon Pension Fund Committee - Investment Panel - Thursday, 16th September, 2010

at 2.00 pm in the Avon Room - Fry Club and Conference Centre

<u>A G E N D A</u>

1. CHAIR'S WELCOME

   To note the appointment of Councillor David Bellotti as Chair of the Panel for the rest of the current Municipal Year.

2. EMERGENCY EVACUATION PROCEDURE

   The Chair will draw attention to the emergency evacuation procedure as set out under Note 9.

3. DECLARATIONS OF INTEREST

4. ITEMS FROM THE PUBLIC - TO RECEIVE DEPUTATIONS, STATEMENTS, PETITIONS OR QUESTIONS

5. APOLOGIES FOR ABSENCE AND SUBSTITUTIONS

   To receive any declarations from Members of the Committee and Officers of personal/prejudicial interests in respect of matters for consideration at this meeting, together with their statements on the nature of any such interest declared.

6. TO ANNOUNCE ANY URGENT BUSINESS AGREED BY THE CHAIR

7. ITEMS FROM COUNCILLORS AND CO-OPTED AND ADDED MEMBERS

   To deal with any petitions or questions from Councillors and, where appropriate, co-opted and added members.

8. MINUTES: 27 MAY 2010 (Pages 1 - 6)

9. PRESENTATION BY TT INTERNATIONAL (Pages 7 - 16)

   Members are requested to note the recommendation that the Appendix to the report be taken in exempt session.

10. ANNUAL REVIEW OF PROPERTY PORTFOLIOS (Pages 17 - 30)

    Members are requested to note the recommendation that Appendix 2 should be taken in exempt session.

11. PASSIVE INVESTING (Pages 31 - 44)

12. PERFORMANCE REVIEW FOR QUARTER ENDING 30 JUNE 2010 (Pages 45 - 100)

13. PANEL WORKPLAN (Pages 101 - 102)

14. ANY OTHER BUSINESS

The Committee Administrator for this meeting is Sean O'Neill who can be contacted on
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BATH AND NORTH EAST SOMERSET COUNCIL

AVON PENSION FUND COMMITTEE

INVESTMENT PANEL

DRAFT MINUTES OF THE MEETING OF 27TH MAY 2010

Present: Cllr Gabriel Batt, Cllr David Bellotti, Ann Berresford, Cllr Mary Blatchford, Andy Riggs, Cllr Gordon Wood

Also in attendance: Tony Bartlett (Head of Business, Finance and Pensions), Tony Earnshaw (Independent Investments Advisor), Liz Feinstein (Investments Manager), David Lyons (Divisional Director, JLT Benefit Solutions)

1 EMERGENCY EVACUATION PROCEDURE

The Clerk read out the procedure.

2 APOLOGIES FOR ABSENCE AND SUBSTITUTIONS

Apologies were received from Bill Marshall, for whom Andy Riggs substituted.

3 DECLARATIONS OF INTEREST

There were none.

4 TO ANNOUNCE ANY URGENT BUSINESS AGREED BY THE CHAIRMAN

There was none.

5 ITEMS FROM THE PUBLIC – TO RECEIVE DEPUTATIONS, STATEMENTS, PETITIONS OR QUESTIONS

There were none.

6 ITEMS FROM COUNCILLORS AND CO-OPTED MEMBERS AND ADDED MEMBERS

A Member asked about the Fund’s exposure to BP in the light of their current environmental problems. The Investments Manager said that the Fund held a large holding within the passive portfolio. She would email the details of the holding to Members the following week.

7 MINUTES: 25TH FEBRUARY 2010

These were approved as a correct record and signed by the Chairman.

8 CURRENCY HEDGING

The Investments Manager presented the report. She said that it summarized all the work that had been done by the Panel in this area to date. It was proposed to actively hedge US Dollar, Euro and Yen denominated equities and to appoint a non-discretionary currency manager to implement this.

A Member asked about the size of the pool of suitable managers. The Investments Manager thought there would be about eight. The mandate would be tightly specified, to eliminate those practising active currency management rather than hedging. Mr Lyons said that five had been identified at the time of the original definition, though and additional one or two might have entered this field since.

A Member asked what the effect on the Fund would have been of implementing active currency hedging over the past twelve months. The Investments Manager replied that hedging would only be implemented when it was favourable to the Fund to do so. As sterling had been weakening there would have been no need to hedge against currency exposure. Hedging was more costly when there were frequent small movements in sterling so that the hedge would be put on and taken off more frequently. It was more profitable to implement hedging when there was a trend in relative currency values. The Member said that he was concerned that hedging required the manager to make judgments about future currency values and that this involved risk. Had the crisis in Greece or the weakening of the Euro been predicted? Mr Lyons responded that active currency hedging could be implemented in a purely mechanistic way, and that over the past twelve months there would have been no hedging of the US Dollar or the Yen, because sterling had been weakening against these currencies. The Independent Investment Adviser said active hedging could be practised without the need to make judgements, through the use of triggers. The Investments Manager explained that the trigger could be the relationship between the current rate of the foreign exchange and its future anticipated rate at that point in time which would create a projected trend line; a hedge would be put on, or removed, if the current rate rose above, or fell below, the trend line. This eliminated the need for judgment in the process.

It was agreed that Members should be involved in the appointment of the manager for the mandate. It was agreed that a special meeting of the Panel should be convened and that Panel Members able to attend that meeting would be involved in the selection of the manager but that the process should be delegated to officers.

RESOLVED to recommend to the Avon Pension Fund Committee:

(i) to appoint a specialist manager to implement an active currency hedging mandate over all US Dollar, Euro and Yen denominated equity assets (excluding those in emerging markets);

(ii) to agree that the manager to be appointed a non-discretionary quantitative approach to active currency hedging;

(iii) agree to delegate the appointment process to Officers in consultation with the Chair of the Committee and Members of the Investment Panel.

9 GLOBAL EQUITY – TENDER PROCESS

The Investments Manager presented the report. The appointment of a global equity manager had been agreed at the last meeting of the full Committee; the report set out the tender process for this appointment. She invited Members to comment on the two options for the selection meeting given in paragraph 4.5 of the report.

A Member asked whether there could be a two-stage process, with the Panel making a recommendation to the full Committee, which would take the final decision. The Investments Manager was concerned that this would cause significant delay in making the appointment.

After discussion it was **RESOLVED** that the Investment Panel would recommend to the Avon Pension Fund Committee to agree the proposed tender process for the Global Equity Tender as set out in 4.3 and that the selection meeting should be constituted as a special meeting of the Investment Panel with authority to appoint (which would be open to other Members of the Avon Pension Fund Committee who wished to attend).

10 REVIEW OF INVESTMENT PERFORMANCE FOR QUARTER ENDING 31 MARCH 2010

RESOLVED that, having been satisfied that the public interest would be better served by not disclosing relevant information, and in accordance with the provisions of Section 100(A)(4) of the Local Government Act 1972, the public be excluded from the meeting for the following item of business because of the likely disclosure of exempt information as defined in paragraph 3 of Part 1 of Schedule 12A of the Act as amended.

The Investments Manager presented the report. She explained that because of the timing of today's meeting the report was less detailed than the report to be presented to the next meeting of the full Committee. She noted that during the period the policy decision to change the allocation of 60:40 UK: Overseas equities to 45:55 had been implemented. Also the tactical position overweight corporate bonds/underweight gilts had been reversed in January when the reversal point was triggered, realising a net benefit of £4.2m. She drew attention to the information in paragraph 4.8 of the report, relating to the underperformance of the Fund relative to the average fund in the WM Local Authority Fund universe.

The Head of Business, Finance and Pensions drew attention to paragraph 5.2 of the report which stated that two policy issues would be placed on future agendas of the policy, namely (1) the level of assets managed by one manager; (2) the allocation to emerging markets.

A Member noted that there was a widening gap between the rolling three-year return and the rolling three-year benchmark return shown in the graph on page 14 of the JLT review. The Investments Manager replied that the widening of the gap in 2008-09 was due to the particularly poor performance of hedge funds against their cash based benchmarks.

A Member noted the poor return on the cash holdings of the Fund, as reported on page 15 of the review. She wondered whether some of this could be invested in property. The Investments Manager said that a balance had to be struck between having sufficient liquidity ready to invest in property and maximising returns. Equities managed by BlackRock had been sold when the equity market had rallied, and the aim was to maintain 25% of the assets earmarked for property in cash. The Independent Investment Adviser noted that Partners had managed a property portfolio for the Fund for almost a year, yet there was no commentary about them. Mr Lyons replied that there was information about the Fund's investment in property on page 16 of the review. The Investments Manager said that qualitative information, about Schroders and Partners would be included in the September performance report; however, quantitative data would not be particularly insightful at this early stage of investing.

A Member was pleased to note that statement on page 19 of the review that *"the total Fund has benefited from diversification by asset classes, as Fund volatility is lower* *than the equity managers and the BlackRock multi-asset portfolio, despite these making up a large proportion of the total assets."*

A Member wondered whether the performance of BlackRock, as reported on page 32 of the review, should be a cause of concern, in that their return was considerably in excess of expectations. This made her worry whether they were taking excessive risks. The Investments Manager said that this was because the tactical switch of equities v. bonds and the UK:Overseas rebalancing had been done through them. In addition, surplus cash had been invested through them.

The Chair asked how the markets were reacting to the Government's attempts to reduce the UK budget deficit. Mr Lyons said that the cuts announced so far had been favourably regarded, but global events, such as the situation in Greece and the decline in the Euro, were the major preoccupations.

A Member asked about the performance of the Fund relative to other local authority Funds. The Investments Manager said that over the year the Fund had lagged against the average of funds in the WM universe. This was because relative to other funds the Fund was underexposed in equities and slightly overweight in bonds and hedge funds. Over a three-year period, however, the Fund was ahead of the WM universe aided by the diversification out of equities. However, annual performance comparisons were becoming more difficult because the Funds in the WM universe have adopted increasingly diverse asset allocation strategies.

RESOLVED to note the Fund's return on investments and details of manager performance as set out in the report.

The meeting returned to open session.

11 HEDGE FUND REVIEW – BRIEF

The Investments Manager presented the report. She said that she thought it was important for the full Committee to be involved in the review because it was a strategic issue.

A Member said that there was a great deal of activity worldwide on the regulation of hedge funds. He believed that the Committee should receive a report on changes in regulation and potential implications to set the scene for the review. After some discussion it was agreed that it would be appropriate for the officers to commission an independent report on regulation from lawyers or other expert advisors to complement the information from the investment consultant and fund of hedge fund managers. It was agreed that the review of trends in regulation should be done in parallel with stage (2), the strategic review by the investment consultant.

RESOLVED to recommend the proposed brief to the Avon Pension Fund Committee, with the addition of a review of the emerging international regulatory environment to be done in parallel with the strategic review by the investment consultant.

12 PANEL WORKPLAN

The Investments Manager presented the report. She said that it might be difficult to have a meeting of the Panel in September and that she would be consulting Members about an alternative date. Meeting hedge fund managers was a priority.

A Member said that the Partners portfolio was a complicated one and that it would be helpful for Members to have a summary of the current state of play. The Investments Manager undertook to provide an overview.

RESOLVED to recommend the workplan to the Avon Pension Fund Committee.

13 ANY OTHER BUSINESS

The Chair thanked Members and Officers for their contributions during the Panel's first year. Nominations for membership for the next year would be taken at the next meeting of the full Committee.

The meeting finished at 3.10pm.

Chair…………………………………………………

Date confirmed and signed………………………

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Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**	
MEETING DATE:	**16 SEPTEMBER 2010**	**AGENDA ITEM NUMBER**
TITLE:	**TT's Holding in BP**	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of Attachments: Exempt Appendix 1 – TT UK Equity Mandate - Positioning in BP		

1 THE ISSUE

1.1 The Committee considered a brief on the implication and effects of the recent BP oil spill at their meeting on 25 June 2010. Following concerns about TT's actions regarding their holding in BP, the Committee requested a written response from TT to explain their investment decisions on BP since the oil spill, and also requested they present the explanations to the Investment Panel so that they could respond to any supplementary questions by the Panel.

1.2 TT's response is in Exempt Appendix 1 and they are attending the meeting to present their explanation and respond to any questions. The response from TT will also be included in the Committee papers for their meeting on 24 September 2010.

1.3 Following the presentation, the Panel are asked to identify any issues with TT and recommend any action required to the Committee.

2 RECOMMENDATION

The Panel agrees:

2.1 **Whether or not to make any recommendations to the Committee regarding this issue**

3 FINANCIAL IMPLICATIONS

3.1 A manager's evaluation of the risks within their stock selection process will impact the potential returns to the Fund.

4 TT ACTIONS ON BP

4.1 At the time of the BP oil spill on 22 April 2010 TT's portfolio was underweight BP compared to the index. This reflected their view that Shell provided better relative value within the UK oil sector. They subsequently reduced this overweight position in BP in May 2010 by buying BP shares, thereby returning to a more neutral position versus the index.

4.2 Following TT's purchase of BP shares, the BP share price continued to fall as further information about the oil spill became available.

4.3 TT's response in Appendix 1 provides further detail on how the investment decisions developed and the assumptions on which the decisions were based. It also quantifies the effects of those decisions on the portfolio.

4.4 TT's portfolio currently has a neutral weighting in BP.

4.5 The BP share price at 2 September 2010 remains below the price at which TT bought BP shares in May 2010.

5 RISK MANAGEMENT

5.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in place that is regularly monitored. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

6 EQUALITIES

6.1 An equalities impact assessment is not necessary.

7 CONSULTATION

7.1 N/a

8 ISSUES TO CONSIDER IN REACHING THE DECISION

8.1 No decisions are being made. The issues being considered to make a recommendation to the committee are contained in the report and comments are sought in the report.

9 ADVICE SOUGHT

9.1 The Council's Monitoring Officer (Council Solicitor) and Section 151 Officer (Divisional Director - Finance) have had the opportunity to input to this report and have cleared it for publication.

Contact person	Liz Feinstein, Investments Manager 01225 395306
Background papers	
Please contact the report author if you need to access this report in an alternative format	

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Bath & North East Somerset Council

Access to Information Arrangements

Exclusion of access by the public to Council meetings

Information Compliance Ref: LGA-10-015a

Meeting / Decision: Avon Pension Fund Investment Panel Meeting
Date: 16th September 2010

Author: Liz Feinstein
Report Title: TTs Holding in BP Exempt Appendix Title: Appendix 1 – TT UK Equity Mandate - Positioning in BP

Stating the exemption: 3. *Information relating to the financial or business affairs of any particular person (including the authority holding that information).*

The public interest test has been applied, and it is concluded that the public interest in maintaining the exemption outweighs the public interest in disclosure at this time. It is therefore recommended that the committee resolve to exclude the public. The paragraphs below set out the relevant public interest issues in this case.

PUBLIC INTEREST TEST

If the Committee wishes to consider a matter with press and public excluded, it must be satisfied on two matters.

Firstly, it must be satisfied that the information likely to be disclosed falls within one of the accepted categories of exempt information under the Local Government Act 1972. Paragraph 3 of the revised Schedule 12A of the 1972 Act exempts information which relates to the financial or business affairs of the investment managers which is commercially sensitive to the investment managers. The officer responsible for this item believes that this information falls within the exemption under paragraph 3 and this has been confirmed by the Council's Information Compliance Manager.

Secondly, it is necessary to weigh up the arguments for and against disclosure on public interest grounds. The main factor in favour of disclosure is that all possible Council information should be public and that increased openness about Council business allows the public and others affected by any decision the opportunity to participate in debates on important issues in their local area. Another factor in favour of disclosure is that the public and those affected by decisions should be entitled to see the basis on which decisions are reached.

Weighed against this is the fact that the exempt appendices contain the investment strategies of the investment managers. It would not be in the public interest if advisors and officers could not express in confidence opinions which are held in good faith and on the basis of the best information available. The information to be discussed is also commercially sensitive and if disclosed could prejudice the commercial interests of the investment managers.

It is also important that the Committee should be able to retain some degree of private thinking space while decisions are being made, in order to discuss openly and frankly the issues under discussion relating to the investment managers in order to make a decision which is in the best interests of the Fund's stakeholders.

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Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**	
MEETING DATE:	**16 SEPTEMBER 2010**	**AGENDA ITEM NUMBER**
TITLE:	**ANNUAL REVIEW OF PROPERTY INVESTMENTS**	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of Attachments: Appendix 1 – Overseas portfolio investment structure Exempt Appendix 2 – Partner's IMA Guidelines (Current and Proposed) and Partner's rationale for change Appendix 3 – Definitions of terms within Partners IMA Guidelines		

1 THE ISSUE

1.1 The Fund invests in property via property funds, with the UK portfolio managed by Schroders and the overseas portfolio managed by Partners.

1.2 The illiquid nature of property assets heightens the importance of portfolio planning when compared with managers of more liquid assets, and requires the property managers (and therefore the Fund) to take a long term investment horizon. Each manager's investment strategy (and how that strategy is implemented) is reviewed annually in the light of new investment opportunities and reinvestment of any asset sales within each portfolio.

1.3 The managers presented their investment strategy to the Investment Panel at the workshop on 16 September and this report sets out the current investment strategy for each manager.

2 RECOMMENDATION

The Panel recommends that the Committee:

2.1 **Approves the changes to the IMA guidelines for the property portfolio managed by Partners**

2.2 **Authorises the Panel and/or Officers to review the property portfolios annually and agree changes to the investment guidelines as appropriate, referring any strategic changes for agreement by the Committee**

3 FINANCIAL IMPLICATIONS

3.1 The monies earmarked for investment in property but not yet invested, are currently managed by BlackRock within a multi-asset passive portfolio. The officers manage the cash flow requests from the property managers.

3.2 When the decision was taken to invest 10% of assets in property the value of the Fund was £2.4bn thus the 10% allocation was £240m and this amount was set aside for investment in property. However, by the time the property managers were appointed in 2009 the Fund value had fallen to £1.8bn thus the initial monies allocated to property at that time was £180m or £90m to each manager.

3.3 The allocation to each manager will be increased by £20m to bring the allocation to each manager in line with the strategic benchmark (to be funded from the assets earmarked for investment in property) and this first annual review of the managers' strategies takes this into account.

4 SCHRODER – ANNUAL REVIEW OF UK PROPERTY PROGRAMME

4.1 Schroder began investing the Fund's assets in 2Q09 and set out an investment programme to be fully invested within 2 years. As at 2Q10, £75.5m or 84% of £90m has been invested. The remaining amount has been fully committed by Schroder, and is awaiting calls from the underlying fund managers, the timing of which is at the discretion of those managers and mainly depends upon them finding direct property assets to purchase.

4.2 Schroder invest in a range of property funds controlled by different asset managers, a "multi-manager" approach. This approach aims to achieve diversification (of assets/sectors, managers and styles), and provide access to specialist management and a variety of asset types. This approach benefits from scale.

4.3 Within Schroder's portfolio the Fund holds investments in 13 separate funds/unit trusts that are both open ended and closed ended funds. The target allocation is 55% in 'core', 35% in 'value added' and 10% in 'opportunistic', where core investments are properties whose key element of return is stable rental income, value added investments are properties that seek returns from both capital appreciation and income, and opportunistic investments which focus mainly on capital gains through active asset management.

4.4 Schroder's investment process involves 'top down' research on the market and other macro factors and a 'bottom up' element focussing on each individual investment and the underlying assets. These are brought together in the portfolio construction process which incorporates risk controls.

4.5 The portfolio has investment restrictions. These include a maximum sector variance of +/- 10% to the benchmark, a maximum 20% in a single fund, a maximum 30% with a single manager, and a minimum of 12 funds.

4.6 Schroder presented their strategy to the Investment Panel at the workshop held 16 September 2010. The portfolio is positioned to reflect Schroder's "house" view on the various UK property sectors. Currently it has overweight positions to shopping centres, retail warehousing, central London offices and alternatives, with an underweight allocation to high street retail, rest of UK offices and

Industrial. The target weightings, once the final investments have been drawn down, will move Industrial to an overweight position leaving only high street retail and rest of UK offices as underweight.

4.7 In the early phases of any property mandate whilst the portfolio is being established, performance data is less meaningful. The Officers are monitoring performance over this period, but it is only after a period of 2 years from inception that performance data becomes a meaningful reflection of value added by the investment process (from inception, i.e. including transactions costs). In Schroder's case this will be around 2Q 2011.

4.8 There are no operational issues to bring to the Panel's attention and performance was reviewed at the workshop.

5 PARTNERS – ANNUAL REVIEW OF OVERSEAS PROPERTY PROGRAMME

5.1 Partners began investing in 3Q09. As at 2Q10, £32m or 35% of £90m has been invested; however the whole amount has been committed to investment programmes.

5.2 Partners presented their strategy to the Panel at the workshop held 16 September 2010. The investment approach adopted by Partners is commonly used for private equity investment. Investment is through "closed end funds" with a finite life. As a result, each investor has to agree their "commitment" or amount they will invest for the finite period at the outset and the manager will gradually invest the committed funds over time. This approach is preferred for less liquid long term investments where the investment programme cannot be disrupted by large scale redemptions (which happens within "open ended funds" such as unit trusts). It also allows investments across "vintage" years (the year in which the first investment is drawdown from the committed capital, which enables the manager to spread the investments over the investment cycle, i.e. allows an element of market timing). The main disadvantage is that the investment is less liquid than open ended property funds. A fuller explanation of the investment structure is in Appendix 1.

5.3 The underlying funds in which Partners invests the Fund's monies have finite lives of up to 10-12 years with a facility to extend this by up to 3 years if the market conditions make it difficult to sell the investments within the 10 year period. In practice, investments within each fund may be realised over time within the 10 years, and these "distributions" will need to be re-invested if the Fund is to retain its target exposure.

5.4 As a result, Partners will review the investment strategy and the implementation of that strategy annually and propose changes as appropriate to accommodate changes in the market outlook and re-investment of distributions. The annual review may necessitate changes to the IMA guidelines within which the overall investment programme is constructed to reflect the market outlook.

5.5 The current IMA guidelines are in Exempt Appendix 2 (see Appendix 3 for guideline definitions). The overall investment strategy is reflected in the allocations between Core, Value-added and Opportunistic investments as these types of property investments have differing risk/return characteristics and in aggregate they generate the overall risk/return profile for the portfolio. The other portfolio guidelines i.e. allocations between geographic regions and type of investment instrument, reflect how the overall strategy will be implemented. As the outlook for property (in terms of the range of investment opportunities available) will change over time, so these guidelines will evolve over time.

5.6 Given the current outlook for property, Partners have not sought to invest in "core" investments (high quality, income generating assets). In current market conditions where there are many distressed sellers of property assets (not distressed assets), they have favoured value added investments. They think that over the next 18 months, the property cycle will favour core investments again so anticipate investing more in core investments going forward.

5.7 In addition, they favour "secondary" investments where fund units or assets are bought from a seller (rather than primary investment, where the assets have yet to be developed or acquired). Secondary investments generally have lower risk than primary investments as the visibility of the underlying assets are far greater.

5.8 Lastly, in general they favour Asia and the Pacific region over the US and Europe, as the property markets in the US and Europe have been more affected by the credit crisis and economic slowdown than the developed markets within Asia and the Pacific.

5.9 To accommodate their revised investment outlook Partners have proposed amendments to the IMA guidelines to increase the allocation to secondaries, direct investments, and Asia, whilst reducing the minimum allocation to primary investments. The proposed changes are set out in Exempt Appendix 2 along with the rationale provided by Partners for the changes. Definitions of terms in the Guidelines can be found in Appendix 3. Partners are not proposing changes to the strategic guidelines on the allocations between core, value added and opportunistic investment types. The Panel are asked to recommend the revised guidelines to the Committee.

5.10 At this early stage of investing the portfolio, performance data is less meaningful due to the low investment level and initial transaction costs. The Officers are monitoring performance over this period, but it is only after a period of 2 years from inception that performance data becomes a meaningful reflection of value added by the investment process (from inception, i.e. including transactions costs). In Partners case this will be around Q3 2011.

5.11 There are no operational issues to bring to the Panel's attention and performance was reviewed at the workshop.

6 FUTURE ANNUAL REVIEWS

6.1 The Panel is asked to consider whether the annual reviews of the property mandates should be delegated to the Investment Panel and/or Officers rather than being presented automatically to the Committee. The reasoning for having delegated powers is that the Panel and Officers will have greater insight and knowledge to make a judgement of the managers' investment guidelines. Any changes of a strategic nature i.e. that materially affect the risk return profile of either property portfolio will be referred to full Committee.

7 RISK MANAGEMENT

7.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in place that is regularly monitored. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

8 EQUALITIES

8.1 An equalities impact assessment is not necessary.

9 CONSULTATION

9.1 N/a

10 ISSUES TO CONSIDER IN REACHING THE DECISION

10.1 No decisions are being made. The issues being considered to make a recommendation to the committee are contained in the report and comments are sought in the report.

11 ADVICE SOUGHT

11.1 The Council's Monitoring Officer (Council Solicitor) and Section 151 Officer (Divisional Director - Finance) have had the opportunity to input to this report and have cleared it for publication.

Contact person	Liz Feinstein, Investments Manager 01225 395306
Background papers	
Please contact the report author if you need to access this report in an alternative format	

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Appendix 1: Partners Group Overseas Property Portfolio Structure

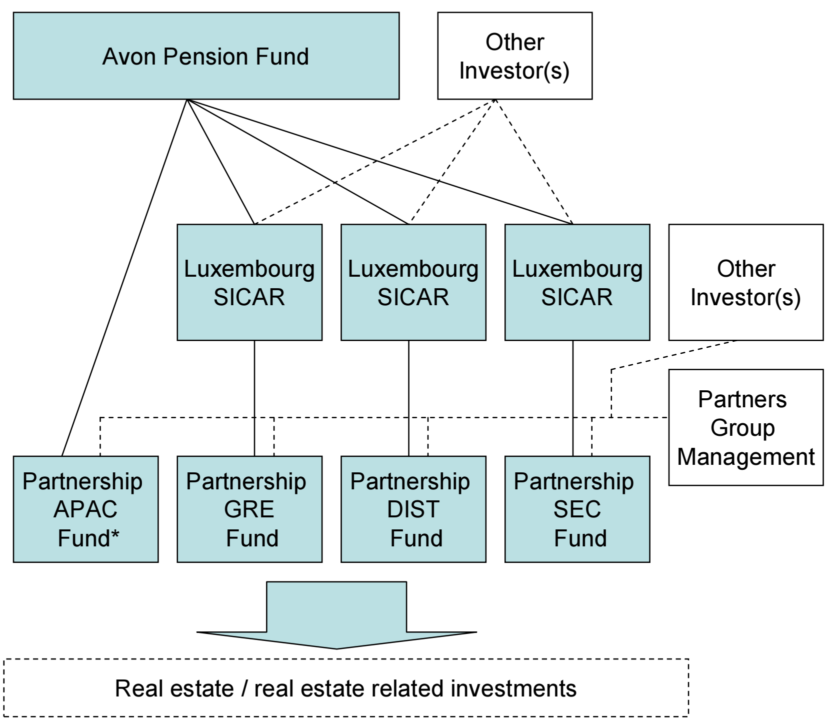
Approach

The investment approach adopted by Partners Group is to invest in closed end funds with a finite life, typically 10 – 12 years, similar to that which is commonly used with private equity investments. This is designed for long term investors but the main disadvantage is that the investment is less liquid than an open ended property fund (where the client may buy/sell units at any time). This structure does have several advantages, for example, the investment program is not disrupted by large scale redemption requests and it enables the manager to invest across different "vintage" years. A "vintage" year refers to the year in which the committee capital is drawdown and invested. By investing across different years the manager is able to "market time" a particular investment across the property cycle rather than invest all the capital at the same time. This contrasts to more liquid assets such as bonds and equities, where managers are able to market time the investment cycle on a constant basis.

Legal Structure

The closed end fund is in the form of a Scottish limited partnership. Were it not for the need to minimise the Fund's tax administration burden (which can be significant for property in some overseas jurisdictions), the Fund would be investing directly in the partnership. However, since the Avon Pension Fund (APF) wishes to minimise the tax payable and avoid the time and effort involved in recovering with-holding tax on its income, particularly from the United States, it has invested in the Partnerships via a SICAR (Societe d'investissement en capital a risqué), i.e. the SICAR serves as a 'feeder fund' and is a limited partner in the Partnerships, not the APF. The advantage of this is that the manager of the SICAR will take responsibility for tax recovery on a corporate basis. Only in the case of investment in Asia-Pacific & Emerging Markets, where there is less withholding tax that can be reclaimed and recovery is easier, will the APF be investing directly in a Partnership. The structure is summarised in Figure 1 below.

Fig1: **Structure of APF investments with Partners**



*NB APF invests directly in the APAC Fund Partnership.

Notes:

APF invest in a pooled 'feeder' vehicle, a SICAR.

The SICAR invests in a Limited Partnership which is the master fund. As such, the SICAR itself becomes a partner in the Partnership.

Each SICAR only invests in one individual Limited Partnership (APF have investments with 4 limited partnerships, 3 via SICARs, 1 directly).

Each Limited Partnership invests in various property funds and direct assets, and realises those assets within a 10 -12 year period.

Each Partnership is managed by a 'general partner'. In each case this is Partners Group.

A Partnership is similar to a fund of funds in that it will invest principally in a range of funds. The General Partner invests money which it has received from the Limited Partners in instalments (so-called capital calls or drawdowns) during its investment period, sells the investments within a finite period and then returns cash to the Limited Partners. Where the Partners Group funds invest in underlying real estate funds, these underlying funds (i.e. portfolio funds of the Partners Group funds) operate in the same way. In the case of the Fund's overseas property investment Partners Group are the General Partner. The Limited Partnerships in which the Avon Pension Fund has invested have a finite life of 10 – 12 years with a facility to extend this by three one-year extensions if not all investments have been realised by the underlying partnerships during the initial term of 10 – 12 years. In practice investments may be realised at any time but will normally be held for at least 5 years.

All 3 SICARs have independent auditors (PwC), custodians (KBL European Bankers) and registrars (Kredietrust). The Asia-Pacific & Emerging Markets Limited Partnership is audited by PwC.

Implications for Control
In addition to the tax advantages, this legal structure has the following implications for control:

i) Termination in the event of underperformance

In the event of underperformance, the Avon Pension Fund has a limited course of action. The only way of terminating the mandate is to transfer the Fund's interests in the Partnership to a third party. However, this facility may be more theoretical than real because the probability of a third party wishing to invest with an underperforming manager is not high.

This is mitigated by the fact that cash is automatically returned to investors when an investment is sold and there is some scope to reduce our holdings with Partners Group by choosing not to re-invest this cash with them. In these circumstances, if the Fund wanted to maintain its overseas property exposure, it would have to appoint a new manager.

ii) Representation and control of the SICAR

Legally, the SICAR is required to be 50% owned by the manager (i.e. the equivalent of a general partner in connection with a limited partnership) (who is Partners Group). Accordingly, a SICAR issues manager shares and ordinary shares which carry each one vote per share. This means that Partners Group are potentially able to exercise a majority of votes and theoretically control the SICAR as well as advising on the investment strategy. In practice they have agreed to vote their 50% share in line with the will of the majority of the other investors. Further, the manager must have regard to its fiduciary duties as manager of the SICAR.

Bath & North East Somerset Council

Access to Information Arrangements

Exclusion of access by the public to Council meetings

Information Compliance Ref: LGA-10-015

Meeting / Decision: Avon Pension Fund Investment Panel Meeting
Date: 16th September 2010

Author: Liz Feinstein
Report Title: Annual Review of Property Investments Exempt Appendix Title: Appendix 2 – Partner's IMA Guidelines (Current and Proposed) and Partner's rationale for change

Stating the exemption: 3. *Information relating to the financial or business affairs of any particular person (including the authority holding that information).*

The public interest test has been applied, and it is concluded that the public interest in maintaining the exemption outweighs the public interest in disclosure at this time. It is therefore recommended that the committee resolve to exclude the public. The paragraphs below set out the relevant public interest issues in this case.

PUBLIC INTEREST TEST

If the Committee wishes to consider a matter with press and public excluded, it must be satisfied on two matters.

Firstly, it must be satisfied that the information likely to be disclosed falls within one of the accepted categories of exempt information under the Local Government Act 1972. Paragraph 3 of the revised Schedule 12A of the 1972 Act exempts information which relates to the financial or business affairs of the investment managers which is commercially sensitive to the investment managers. The officer responsible for this item believes that this information falls within the exemption under paragraph 3 and this has been confirmed by the Council's Information Compliance Manager.

Secondly, it is necessary to weigh up the arguments for and against disclosure on public interest grounds. The main factor in favour of disclosure is that all possible Council information should be public and that increased openness about Council business allows the public and others affected by any decision the opportunity to participate in debates on important issues in their local area. Another factor in favour of disclosure is that the public and those affected by decisions should be entitled to see the basis on which decisions are reached.

Weighed against this is the fact that the exempt appendices contain the investment strategies of the investment managers. It would not be in the public interest if advisors and officers could not express in confidence opinions which are held in good faith and on the basis of the best information available. The information to be discussed is also commercially sensitive and if disclosed could prejudice the commercial interests of the investment managers.

It is also important that the Committee should be able to retain some degree of private thinking space while decisions are being made, in order to discuss openly and frankly the issues under discussion relating to the investment managers in order to make a decision which is in the best interests of the Fund's stakeholders.

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Appendix 3: Definitions of Terms within Partners Investment Guidelines

<u>"Core Investments"</u> are investments in well-managed properties that are occupied by quality tenants and leased to capacity. Returns predominantly stem from current net operating income and to a lesser extent, from capital appreciation.

<u>"Value added Investments"</u> are investments in properties which are considered undervalued due to sub-optimal management. The objective is typically to improve net operating income (and thereby property value) through renovation, releasing, repositioning, redevelopment, improved management and/or similar measures. Returns from such assets are typically a mix of current income and capital gains.

<u>"Opportunistic Investments"</u> are investments in development projects, turnaround projects or special situations such as distressed real estate assets. The objective is to create or significantly improve net operating income through repositioning, redevelopment, implementation of a new development and/or substantially improved property management. The creation of a regular net operating income stream ultimately translates into substantial capital gains which are the predominant source of returns.

<u>"Primary Investments"</u> are interests (including all related Securities) in Portfolio Funds, which are acquired directly from the relevant vehicle's general partner or other managing agent.

<u>"Secondary Investments"</u> are interests (including all related Securities) in (i) Portfolio Funds, (ii) investment vehicles that invest predominantly in Portfolio Funds, and/or (iii) Direct Investments, which are (in each case) acquired in the secondary market.

<u>"Direct Investments"</u> are interests (including all related Securities) in (typically unlisted) Real Estate Investments.

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Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**	
MEETING DATE:	**16 SEPTEMBER 2010**	**AGENDA ITEM NUMBER**
TITLE:	**PASSIVE INVESTING**	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of Attachments: Appendix 1 – Performance of passive portfolio Appendix 2 - Concentration within main Equity Indices		

1 THE ISSUE

1.1 The Panel's meetings with the investment managers and the decline in the value of BP have raised the following issues/risks for the Panel to consider:

(1) The size of the allocation to any single passive manager

(2) The impact of concentration within an index on the performance of a passively managed portfolio.

1.2 This report addresses the issues and puts forward possible approaches for managing these risks in the future. The Panel are asked to consider whether any recommendations should be made to the Committee or whether any further work is required.

2 RECOMMENDATION

That the Investment Panel agrees the recommendations to be made to the Committee as follows:

2.1 **Whether to make changes to the current passive management structure**

2.2 **Whether the current allocation to passively managed UK equities should be reduced, and if so how this should be implemented**

3 FINANCIAL IMPLICATIONS

3.1 The allocation between passive and active mandates determines the investment management fees charged to the Fund. Passive management incurs significantly lower fees than active management due to the lower level of resource required to manage the portfolios.

4 CONTEXT: STRATEGIC INVESTMENT POLICY

4.1 The strategic investment policy targets a risk adjusted investment return over a long time horizon. The policy is then implemented via a number of investment management mandates which enables the Fund to diversify both its investment and manager risk. This means that the Fund has a “risk budget” which needs to be allocated between the various asset classes and managers. In 2007, when the current strategy was established, the Fund adopted a more aggressive approach to active investing by allocating to less constrained active mandates with higher volatility levels compared to the underlying index they were benchmarked against. As a result, in order to meet the Fund’s “risk budget” the assets allocated to active investing were reduced and the allocation to passively managed investments was increased from c. 38% to the current core allocation of 46% (see below for explanation of core allocation).

4.2 In addition, under the current strategy, 10% of total assets are managed on an enhanced indexation basis (these are overseas equities). This is a form of low risk active management which utilises quantitative models with the objective of generating excess returns in region of 0.5% p.a. on a consistent basis, without significantly increasing the risk profile compared to passive investing. This is achieved by the managers taking numerous small positions away from the underlying index, but as a result the portfolio overall will closely mirror the index. Therefore the allocation to passive and very low risk active mandates is c. 56% of total assets.

4.3 Altering the allocation between passive and active equities will marginally affect the overall risk return profile of the Fund. Active investing assumes higher expected returns (compared to the index). However, volatility will also increase due to stock selection risk and, for overseas equity portfolios, currency exposure risk (however the Fund will be hedging currency exposure in the future). To put this into context, for every 10% switched from a passive UK to an active UK equity mandate (with an index +2% performance target), the increased return at the overall Fund level would be +0.2% and the expected increase in volatility at the overall Fund level would be 0.1% (the volatility of the overall Fund is currently c.11%).

5 CONTEXT: CURRENT PASSIVE PORTFOLIOS

5.1 The Fund currently has two passive investment portfolios both managed by BlackRock. The “main fund” is the core allocation to passive investing and is a multi-asset portfolio. The “property account” was created in 2007 and is a passively managed portfolio of the assets earmarked for investing in property. The property fund is therefore not a core allocation to passive investments but a temporary and cheaper option for managing the assets in the interim. The two passive portfolios are as follows:

	Asset Value	% of total Fund assets
Main Fund	£1,181m	51.4%
Property Account	£120m	5.2%
Total	£1,302m	56.6%

5.2 The main fund includes allocations to UK equities, overseas equities, UK gilts and index-linked bonds. The allocation to government bonds is managed on a passive basis given the limited opportunities for active managers to outperform the government bond indices net of fees. In the 2007 strategic review, the decision was taken to manage the corporate bond portfolio on an active basis. This is because there is more scope to outperform the corporate bond index and avoid default risk if such assets are managed on an active basis.

5.3 In December 2009 the Committee agreed to increase the allocation to overseas equities from 40% to 55% of the equity assets. This was implemented by reducing the allocation to passively managed UK equities and investing £130m (6% of total assets) in a passively managed global equity fund and £25m (c.1% of total assets) with the Fund's active emerging market equity manager, Genesis. The allocation to the passive global equity fund was an interim investment until the Fund appointed an active global equity manager to manage the assets (expected implementation 1Q11).

5.4 **Therefore the long term "core" allocation to passive investments, excluding the allocations to both the property account and the global equity fund, is £1,052m or 46% of the Fund's assets.**

5.5 The asset allocation of this "core" passive portfolio is set out in the table below. This demonstrates that the passively managed investments are across a diverse range of assets, both UK and overseas.

Asset class	Allocation within Main Fund	% of Main Fund	% of Total Avon assets
UK Equities	£401m	38.0%	17%
Overseas Equities (1)	£274m	26.0%	12%
UK Gilts	£144m	14.0%	6%
Index Linked Bonds	£152m	14.5%	7%
Overseas Bonds	£74m	7.0%	3%
Corporate Bonds (2)	£4m	0.5%	0%

(1) Overseas equities excludes allocation to Global Equity Fund and comprises of 5 regional funds

(2) Corporate Bonds – bonds set aside to match liabilities where employers have the liabilities and contribution rate calculated on the corporate bond basis.

5.6 The table in Appendix 1 shows the investment returns of the passive portfolio managed by BlackRock and the underlying indices. There is little difference between the index and passive fund returns which shows that a passive approach generates minimal additional risk in terms of investment returns, over and above that associated with market returns. Differences over one year in the bond portfolio are due to timing and cost of large transactions (implementation of tactical bond position).

5.7 In addition analysis of LGPS fund returns over last 10 years by WM Company concludes that the passive portfolios within major equity markets have closely tracked their chosen indices within acceptable limits.

5.8 WM provides some data on the allocation between actively and passively mandates within LGPS funds. The data shows that c. 20% of total assets are managed passively by external managers. It also suggests that up to c. 42% of total assets may be passively managed (internal and external mandates). This is approximate as it assumes that internally managed assets (22% of total assets) are all managed on a passive basis. Within the south west LGPS funds passively managed assets range between 3-37% of total assets with an average of 22% (excluding Avon).

6 ISSUE: ALLOCATION TO ONE PASSIVE MANAGER

6.1 The issue raised by the Panel was whether the allocation to a single passive manager was too high. The main advantage of passive investing is that it reduces manager risk with regard to achieving the investment return target. A passive manager merely replicates the relevant index; there are no stock selection decisions. Therefore a passive portfolio is fully exposed to the market risk of the underlying index and any differences between different passively managed portfolios will be determined by the quantitative model utilised to replicate the underlying index. However, these differences in risk and return are negligible compared to market risk.

6.2 The other key manager risk is the safety of the assets they manage on our behalf. However, all client assets, whether they are passively or actively managed by an investment manager, are ring-fenced and therefore if the manager were to become insolvent, creditors have no claim on the client assets. Segregated assets are held in safe-keeping by the Fund’s custodian and pooled assets have independent custodians. Therefore appointing an additional passive manager will not reduce such risks.

6.3 However, the Fund is exposed to the corporate and operational risk of all managers including passive managers. Corporate risk includes changes in the corporate entity/ownership which could lead to key personnel changes or alter its commitment to passive investing as a business unit. Changes in key personnel for a passive manager are less immediately negative compared to an active manager as the success of passive investing depends on the replication model which is dependent on a team of technically skilled staff, rather than the stock picking skills of individuals. In this respect there is less “key man” risk in passive managers. Operational risks arise from the firm’s custody arrangements and trading processes - these risks are not dissimilar whether an active or passive manager.

6.4 Operational risks are assessed annually as part of the Fund’s review of the passive manager’s internal control report. BlackRock’s independently audited Internal Control Report does not highlight any areas of concern.

6.5 Officers are satisfied with the service received from BlackRock. The team is sufficiently resourced, and the depth and breadth of expertise is appropriate. They have consistently achieved the required performance, indicating that the model used to replicate the indices is efficient (see Appendix 1). BlackRock has a comprehensive engagement and voting programme with investee companies, although it should be noted that the structure of our pooled investments preclude the Fund from any bespoke direction of this activity.

6.6 The acquisition of BGI by BlackRock in 2009 and the resulting integration of the operations has had no negative effect to date on the service provided. However, the officers are monitoring the transition closely as the systems are migrated on to one platform.

6.7 There would also be cost implications of appointing a second passive manager. As the allocation to each manager will be smaller the Fund could incur higher passive fees overall as economies of scale are diluted.

6.8 In addition the multi-asset passive portfolio managed by BlackRock is currently used as the "swing fund" for rebalancing. Therefore the Fund would need to retain a multi-asset passive portfolio to ensure efficient and cost effective rebalancing but having two multi-asset passive portfolios may not be optimum from a cost or monitoring perspective.

7 ISSUE: PASSIVE MANAGEMENT & INDEX CONCENTRATION

7.1 In their review of the Investment Strategy in 2009, JLT set out the advantages and disadvantages of passive and active investment approaches. These are summarized in the following table:

	Advantages	**Disadvantages**
Passive	• Reduced manager risk • Lower governance costs • Lower management costs	• Market weighted indices • No discretion over investment holdings
Active	• Potential for outperformance of index benchmark • Portfolios reflects manager's views • Greater control over portfolio constraints • Greater ability to over-ride/instruct manager on specific issues	• Views relative to benchmark restricted by risk tolerance set by Fund • Higher fees • Higher governance costs • Risk of losing relative value to index benchmark

7.2 On the positive side, passive investing provides lower management fees, lower monitoring costs and reduced investment manager risk (as discussed previously). The main disadvantage of is that market weighted indices are generally used as the basis for replicating the index. This means that passive portfolios own more of what has already increased in value (and vice versa) as the process mechanically increases the weights attributed to stocks that have risen in price relative to the rest. This process of replicating based on the weight of each stock within the index (known as "cap weighted"), gives rise to the effect of “concentration”. In this context concentration means the degree to which the weights of stocks in the index are “skewed” towards larger stocks.

7.3 Concentration is a particular issue within the UK index (FTSE All Share) which is used as the index for most UK equity portfolios. As Appendix 2 shows, the top ten holdings in the FTSE All Share equate to c. 38% of the capitalisation of the index (at 30 June 2010). In comparison, the top ten holdings in the European, US and Global indices are 23%, 19% and 9% respectively.

7.4 The Fund is exposed to concentration risk due to its high allocation to passively managed UK equities. This has been highlighted recently by the sharp fall in the price of BP relative to the UK index. Within the UK equity allocation, 67% is managed passively (17% of total assets) and 33% is managed actively (8.5% of total Fund assets).

7.5 The situation regarding BP is relatively unique in that instances such as this are not a regular occurrence but it raises the issue of how such risks can be managed. One possible approach would be to impose constraints on the managers. However with passive investing there is no discretion over the holdings in the portfolio as they are determined by the underlying index. Any investment decision to move away from the index would undermine a passive approach as it would involve a qualitative judgement and therefore the risk return profile would deviate from that of the underlying index. Specifically for the Fund, the passive equity investments are managed through pooled funds so there is no scope for the Fund to impose discretionary constraints within the current arrangements. Any action would require the Fund to manage its passive investments on a segregated basis or use alternative underlying indices, both of which will increase costs.

7.6 To put BP into the context of the Fund, at the aggregate Fund level, the Fund was under weight BP against the UK index. The passive UK equity portfolio had a full market weight but the other two UK portfolios were underweight. TT International subsequently increased its weight but remained slightly underweight. However, because of the large allocation to passively managed UK equities the unrealised monetary loss on BP shares is c £18.5m as at 2 September 2010.

8 OPTIONS FOR CONSIDERATION

8.1 There are a number of options the Panel could consider for reducing the risk these issues pose to the Fund.

Allocation to passive manager

8.2 If the Panel considers that the risk to the Fund arising from the current allocation to a single passive manager is too high, the Fund could explore the option of appointing a second passive manager. However, as discussed earlier, as there would be no change in the risk return profile of the passively managed assets or the safe-keeping risks, the Panel would need to be satisfied that appointing a second manager would reduce other manager related risks.

8.3 There would also be cost implications of appointing a second passive manager. As the allocation to each manager will be smaller the Fund could incur higher passive fees overall as economies of scale are diluted.

8.4 In addition the multi-asset passive portfolio managed by BlackRock is currently used as the "swing fund" for rebalancing. Therefore the Fund would need to retain a multi-asset passive portfolio to ensure efficient and cost effective rebalancing but having two multi-asset passive portfolios may not be optimum from a cost or monitoring perspective.

Reducing the impact of concentration within the Fund

8.5 Assuming that the Fund wishes to retain the current allocation between passively and actively managed assets, there are a number of options for the Panel to consider:

(1) **Reduce the strategic allocation to the regional/country indices in favour of less concentrated global indices**. This would be in line with the recent decision to reduce the UK equity allocation in favour of a global equity allocation. At 31 March 2010 the average WM LA Fund allocated 44% to UK equities and 56% overseas equities which is very similar to the Fund's current allocation of 45%/55%. It could be implemented within the passive portfolio in a cost effective way.

In their paper of February 2010, JLT provided the following risk and return analysis if the UK equity exposure is reduced in favour of overseas/global equities managed on a passive basis:

UK:Overseas allocation	Expected Market Return	Absolute Volatility
45:55 (i.e. current allocation)	8.5%	16.0%
30:70	8.5%	16.2%

The increase in volatility as the allocation to overseas equities increases is due to the impact of foreign exchange on the investment return. However, foreign exchange risk will be reduced by the active foreign exchange hedge that the Fund will implement in the next few months.

Currently the Fund has 27% of the Fund invested in UK equities (c. 17% passively managed) and 33% in overseas equities. Moving towards a 30:70 allocation would reduce the UK equity allocation to 18% (c. 8% managed passively) and increase the overseas equities allocation to 42% (c. 21% managed passively).

(2) **Explore the use of alternative indices as the benchmark for a passive portfolio**. It may be possible to use benchmarks for passive portfolios that are not cap weighted. For example, there are "fundamentally" based indices which use economic or financial measures rather than market capitalisation to weight stocks within an index. This key point is that these indices will still reflect all the stocks in the underlying index – their weight within the index will reflect a different parameter rather than the market cap. Therefore the risk adjusted return should not differ that significantly from the standard cap weighted index. However, such alternative indices are not widely used or established and therefore there is not a large selection of pooled funds to invest in. Therefore this option may require the passive assets to be managed on a segregated basis which would increase the management fee.

Such an index may also incur higher costs of maintaining the indexation replication model. If the Panel wish to consider this further, a full analysis on the options available would need to be undertaken.

(3) **The other alternative would be to increase the allocation to active management in the markets where concentration is an issue, such as the UK.** However this may alter the overall risk adjusted return target of the overall Fund as discussed in paragraph 4. This option would increase the expected volatility and return compared to a passively managed portfolio (assuming the manager achieves their return target). Active mandates provide the opportunity for client imposed constraints such as, a maximum holding weight or to adopt an approach that excludes certain stocks/sectors. However, active managers are ultimately selected on the basis that their stock picking skills will add value in excess of their benchmark and any constraints should not restrict their ability to deploy that skill.

8.6 These options are summarised in the table below.

Summary of Options to Reduce Impact of Concentration in Passive Portfolio

Option	Advantages	Disadvantages
i) Reduce regional/country allocation in favour of global indices *Reduces concentration risk by increasing allocation to less concentrated global indices*		
	- Retains strategic allocation to passively managed assets	- Small increase in absolute volatility due to effect of foreign currency (will be mitigated by active currency hedging)
	- Can be implemented within passive portfolio in a cost effective way	
	- In line with previous move in equity portfolio from UK to Overseas	
ii) Use alternative indices *Avoids concentration issues by weighting stocks using measures other than market capitalisation*		
	- Retains strategic allocation to passively managed assets	- Not widely used and therefore less choice
	- Retains diversification benefits as still reflects all stocks in an index	- More costly to implement
iii) Increase allocation to active management *Reduces concentration risk by reducing amount of assets managed on a passive basis*		
	- Provides the opportunity for client imposed constraints (although restrictions hamper ability of manger to deploy skill for which they have been selected)	- Alters overall risk adjusted return, increasing volatility and returns
		- Increases cost of management

8.7 The Panel needs to consider whether any recommendations regarding the options set out in section 8 need to be made to the Committee or not.

9 RISK MANAGEMENT

9.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in place that is regularly monitored. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

10 EQUALITIES

10.1 An equalities impact assessment is not necessary.

11 CONSULTATION

11.1 N/a

12 ISSUES TO CONSIDER IN REACHING THE DECISION

12.1 No decisions are being made. The issues being considered to make a recommendation to the committee are contained in the report and comments are sought in the report.

13 ADVICE SOUGHT

13.1 The Council's Monitoring Officer (Council Solicitor) and Section 151 Officer (Divisional Director - Finance) have had the opportunity to input to this report and have cleared it for publication.

Contact person	Liz Feinstein, Investments Manager 01225 395306
Background papers	
Please contact the report author if you need to access this report in an alternative format	

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Appendix 1

Returns of Passive portfolio to 31 March 2010

	1 year		3 years (annualised)	
	Fund	Index	Fund	Index
UK Equities	52.6%	52.3%	-0.1%	-0.2%
US Equities	41.6%	40.6%	-3.9%	-4.6%
Europe ex-UK Equities	52.3%	51.6%	-7.7%	-8.1%
Japan Equities	29.4%	29.5%	-0.7%	-0.8%
Pacific Rim Equities	70.1%	69.1%	13.3%	12.5%
Canadian Equities	62.0%	61.8%	14.0%	13.9%
Global Equities (1)	52.5%	52.4%	-5.2%	-5.4%
Corporate Bonds	21.4%	21.4%	3.8%	3.5%
Overseas Bonds	1.6%	0.0%	17.6%	17.7%
Gilts	3.6%	-0.2%	5.7%	4.4%
Index Linked Bonds	10.3%	10.4%	6.8%	6.8%
Total Portfolio	38.2%	37.6%	3.8%	3.6%

Note (1) Only invested in Global equity fund since January 2010

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APPENDIX 2

Concentration within main Equity Indices (as at 30 June 2010)

	UK - FTSE All Share		Europe x UK - MSCI		USA - S&P		Global - MSCI World	
	Stock	% of Index	Stock	% of Index	Stock*	% of Index*	Stock*	% of Index*
1	HSBC	7.1%	Nestle	4.5%	Exxon Mobil Corp	3.1%	Exxon Mobil Corp	1.4%
2	Vodafone Group	4.9%	Novartis	2.7%	Apple Inc.	2.3%	Apple Inc.	1.1%
3	Royal Dutch Shell - A Sh	4.0%	Roche Holding Genuss	2.60%	Microsoft Corp	2.0%	Microsoft Corp	1.0%
4	BP	4.0%	Total	2.5%	Procter & Gamble	1.8%	Procter & Gamble	0.8%
5	GlaxoSmithKline	4.0%	Banco Santander	2.3%	General Electric Co	1.7%	HSBC HOLDINGS (GB)	0.8%
6	Astrazeneca	3.0%	Telefonica	2.0%	IBM Corp	1.7%	General Electric Co	0.8%
7	Rio Tinto	3.0%	Siemens	2.0%	JP Morgan Chase & Co	1.6%	Nestle	0.8%
8	Royal Dutch Shell - B sh	3.0%	Sanofi-Aventis	1.8%	Johnson & Johnson	1.6%	IBM Corp	0.8%
9	Bristish American Tobacco	2.8%	BNP Paribas	1.4%	AT&T Inc	1.5%	Johnson & Johnson	0.8%
10	BHP Billiton	2.6%	BASF	1.4%	Chevron Corp	1.5%	JP Morgan Chase & Co	0.8%
	Top 10 as % of index	38.4%		23.2%		18.8%		9.1%

Sources: BlackRock
* As at 30 July 2010

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Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**	
MEETING DATE:	**16 SEPTEMBER 2010**	**AGENDA ITEM NUMBER**
TITLE:	**Review Of Investment Performance For Quarter Ending 30 June 2010**	
WARD:	**ALL**	
AN OPEN PUBLIC ITEM		
List of attachments to this report: Appendix 1 – Fund Valuation Appendix 2 – JLT performance monitoring report		

1 THE ISSUE

1.1 This report contains performance statistics for the quarter ending 30 June 2010. The report focuses on the strategic investment policy, the managers' performance to date, a valuation update, portfolio rebalancing and the property portfolio.

1.2 Most of the detail is contained in the appendices. The Fund's investment consultant, JLT, have prepared a report (Appendix 2) covering the performance of the investment strategy, the performance of the investment managers and the market commentary.

2 RECOMMENDATION

That the Investment Panel:

2.1 notes the Fund's return on investments and details of manager performance as set out in the report.

2.2 identifies issues to be notified to the Committee

3 FINANCIAL IMPLICATIONS

3.1 The returns achieved by the Fund for the three years from 1 April 2010 to 31 March 2013 will impact the actuarial valuation which will be struck as at 31 March 2013.

3.2 Section 6 of this report discusses the Fund's liabilities and the funding level.

4 INVESTMENT PERFORMANCE

4.1 Appendix 1 provides a breakdown of the Fund valuation and allocation of monies by asset class and managers.

4.2 JLT's report in Appendix 2 provides a full commentary on the performance of the strategic benchmark (pages 12-16), the investment managers (pages 17-40) and a commentary on investment markets (pages 5-11). In the section on the Fund (page 14), three year rolling returns are included to provide a longer term perspective. Qualitative summaries for the property managers are included for the first time.

4.3 The Fund's investment return and performance relative to benchmarks is summarised in the following table for the periods to 30 June 2010:

	3 months	**12 months**	**3 years (p.a.)**
Avon Pension Fund	-6.1%	18.6%	0.1%
Strategic benchmark *(Fund relative to benchmark)*	-6.0% *(-0.1%)*	18.7% *(-0.1%)*	n/a
Customised benchmark *(Fund relative to benchmark)*	-6.2% *(+0.1%)*	18.4% *(+0.2%)*	1.0% *(-0.9%)*
WM Local Authority Average Fund *(Fund relative to universe)*	-6.8% *(0.7%)*	18.6% *(0.0%)*	-1.7% *(1.8%)*

4.4 The Fund's assets fell in value by £149m (-6.1%) in the quarter giving a value for the Fund of £2,305m at 30 June 2010. This investment return was driven mainly by the falls in equity markets caused by concerns that the austerity measures in Europe and a slowdown in the pace of economic recovery in the US could lead to a double dip recession. Sterling depreciated against the US$ and Yen but it appreciated against the Euro.

4.5 More importantly over the last twelve months the Fund's assets rose by £377m or 18.6%, driven by positive returns across all asset classes, in particular equities and corporate bonds. Hedge funds lagged the rally in equities but generated positive returns.

4.6 The initial estimate for the Fund's return in July is +2.5%. However equity markets have retreated again in August.

4.7 **Against its strategic benchmark** (60% equities, 20% bonds, 10% property, 10% hedge funds) the Fund marginally underperformed over the year. The high cash balance early in the year detracted value whereas the tactical switch from gilts into corporate bonds added value.

4.8 **Against its customised benchmark** (which measures the relative performance of the managers), the Fund marginally outperformed in the quarter. Jupiter had a strong quarter given its lack of exposure to oil stocks. Most of the other managers added value against their benchmark except TT Int'l and the hedge funds.

4.9 Over the year the Fund marginally outperformed the customised benchmark mainly due to the outperformance of Jupiter, Royal London, Genesis and two of the hedge funds.

4.10 Over the last three years the Fund has generated a return of 0.1% p.a. underperforming the customised benchmark return by -0.9%. This is attributable to manager performance. Asset allocation has been a positive contributor.

4.11 **Compared to the WM Local Authority Fund universe**, the Fund is in line with the average fund over the year. Over three years the Fund's return of 0.1% p.a. is ahead of the average fund return of -1.7% p.a.

4.12 The report by JLT identifies no areas of significant concern regarding the managers, but did note that despite a good quarter the SRI constraints on Jupiter may be at the cost of significant volatility relative to the benchmark. The continued underperformance of MAN, although slight last quarter, should be considered when the fund of hedge fund investments are reviewed in 1Q11.

4.13 The Investment Panel has a workshop on 16 September 2010 to review the property portfolios. The purpose of the workshop is to understand the manager's investment process and how it is applied to our portfolios, review the outlook for the property market and discuss future investment strategy.

4.14 The Panel will identify any particular performance or operational concerns to raise with the Committee and these can be found in the paper for the Investment Panel Recommendations item on this agenda.

4.15 In May MAN announced the acquisition of GLG, a global multi-strategy manager. GLG manages a range of funds and managed accounts across equity and bond markets. GLG investment products will complement and broaden the range of products offered by the enlarged group. GLG will operate as an independent investment unit within MAN Group. GLG do not manage fund of hedge funds and therefore will not directly impact the team that manages our investment. Shareholders will vote on the proposal with the outcome of the vote expected 1 September 2010. The acquisition is expected to complete in September 2010.

4.16 Jupiter became a public company in June following its flotation on the London Stock Exchange. The officers will monitor the company closely especially in relation to key man risk. Until the Fund is satisfied that the full impact from this corporate restructuring is known, no new monies should be allocated to Jupiter.

4.17 The search for the new global equity manager is progressing and submissions are currently being evaluated. The process is on schedule to appoint early in the new year.

5 INVESTMENT STRATEGY

5.1 JLT's report did not highlight any new strategy issues for consideration. The report does highlight the risk return profile of the Fund on pages 18 & 19 and the impact on risk/return by each of the managers. In particular JLT conclude that the volatility of the various portfolios/funds is in line with expectations and that the Fund has benefited from diversification by asset classes as the Fund volatility is lower than the equity managers and passive Blackrock portfolio which comprise c.75% of the total Fund.

6 ACTUARIAL VALUATION UPDATE

6.1 At the 31 March 2007 valuation the funding level was 83% (the assets were sufficient to meet 83% of the projected liabilities at that date given the existing investment and funding strategies). The interim valuation at 31 March 2009 estimated that the funding level had fallen to 60%. This was mainly due to the investment returns failing to achieve the 6.3% p.a. assumed in the 2007 actuarial valuation during both 2007/08 and 2008/09. Rolling forward the 2007 valuation assumptions for the 31 March 2010, the funding level was estimated to have risen to 73% driven by the rise in asset values of c. 34.5% since April 2009.

6.2 However, a full triennial actuarial valuation is being undertaken as at 31 March 2010 which will set the employer rates for the three years commencing 1 April 2011. For the 2010 valuation, the Actuary will review the assumptions to be used and will also incorporate the government's recent announcement of changing the inflation rate used to value pension benefits. As part of the valuation process, the Committee will approve the Funding Strategy Statement (FSS) which sets out the parameters for the valuation. The FSS was discussed in depth at the Committee workshop held on 23 July 2010 and is included elsewhere on this agenda.

6.3 The effect of changing the basis of valuing pension benefits from the Retail Price Index (RPI) to the Consumer Price Index (CPI) is to reduce liabilities by between 5-8% (depending on the employer profile) as CPI is normally lower than RPI. (historically CPI has been c. 0.5% lower than the RPI). This difference arises due to the composition of the basket of goods and services used for each index and the method of calculation. The main difference in the underlying baskets is that the CPI does not include housing costs such as mortgage costs or council tax.

6.4 In addition the Actuary is introducing an inflation risk premium (IRP) adjustment to the market derived inflation rate used in the valuation. This adjustment allows for supply/demand distortions in the bond market which is used to derive the implied inflation rate.

6.5 As the 2010 valuation has yet to be completed there is not a quarterly update as at 30 June 2010. However, the estimated funding level at 31 March 2010 incorporating the revised assumptions discussed above is c. 80%. The changes in the Fund's funding level to 31 March 2010 are summarised below:

	Triennial valuation March 2007	Interim valuation March 2008	Interim valuation March 2009	Estimated Mar-10	% change since 2007
Assets (£m)	2,184	2,175	1,819	2,505	15%
Liabilities (£m)	2,643	3,099	3,017	3,126	18%
Deficit (£m)	-459	-924	-1,198	-621	
Funding Level	83%	70%	60%	80%	

6.6 The funding level and increase in the deficit means there is still some pressure on employer contribution rates to rise. However, where possible this will be managed by extending the deficit recovery period beyond the current 15-20 years. Any future reduction in employer costs will first of all be used to reduce this recovery period to more normal 15-20 years. The Fund's officers have met with outsourcing employers and community admission bodies to discuss their specific situation with regard to the valuation.

6.7 Before the 2010 valuation is completed the government may adopt recommendations from the Independent Commission on Public Service pensions (Hutton Commission). This may result in further changes to the 2010 valuation.

6.8 It is anticipated that the total Fund valuation results will be completed by early October. Individual employer contribution rates will be available late October/early November. Officers will be meeting with employers to discuss the outcome of the valuation.

7 CASH MANAGEMENT

7.1 Cash is not included in the strategic benchmark. However, cash is held by the managers at their discretion within their investment guidelines, and internally to meet working requirements. The segregated portfolios, TT, Jupiter and BlackRock utilise money market funds offered by the custodian, BNY Mellon. The cash within the pooled funds is managed internally by the manager. The cash managed by BlackRock in the property portfolio is invested in the BlackRock Sterling Liquidity Fund. The officers closely monitor the management of the Fund's cash held by the managers and custodian with a particular emphasis on the security of the cash.

7.2 Management of the cash held internally by the Fund to meet working requirements is delegated to the Council's Treasury Management Team. The monies are invested separately from the Council's monies and are invested in line with the Fund's Treasury Management Policy which was approved on 18 December 2009.

8 REBALANCING POLICY

8.1 The rebalancing policy requires rebalancing of the Equity/Bond allocation to occur when the equity portion deviates from 75% by +/- 2%, and the valuation metric, in this case the equity gilt yield ratio, confirms that the relative valuation between equities and bonds is favourable. The implementation of this policy is delegated to officers.

8.2 There was no rebalancing undertaken this quarter. As at 4 August 2010 the Equity:Bond allocation was estimated at 74.5:25.6.

9 LAPFF ACTIVITY

9.1 The Fund is a member of the Local Authority Pension Fund Forum (LAPFF), a collaborative body that exists to serve the investment interests of local authority pension funds. In particular, LAPFF seeks to maximise the influence the funds have as shareholders through co-ordinating shareholder activism amongst the pension funds.

9.2 LAPFF's current activity includes:

(1) BP - The Forum will continue to engage with BP, having built a good relationship with the company in the recent past. LAPFF is planning to seek a meeting with the company to learn more about the company's response to the crisis. Forum members will be updated as soon possible.

(2) The Financial Reporting Council (FRC) has published the first Stewardship Code for institutional investors. This Code will replace the Combined Code. The purpose of the Code is to improve the quality of corporate governance through promoting better dialogue between shareholders and company boards, and more transparency about the way in which investors oversee companies they own. The Code includes principles on:-

- The monitoring of investee companies;
- The escalation of activities taken to protect or enhance shareholder value;
- Collective engagement;
- Voting policy;
- Managing conflicts of interest; and
- Public reporting and reporting to clients.

It is intended that a paper on the FRC Stewardship Code will be brought to the December committee meeting. LAPFF will be providing guidance on how funds can apply the Code.

10 RISK MANAGEMENT

10.1 A key risk to the Fund is that the investments fail to generate the returns required to meet the Fund's future liabilities. This risk is managed via the Asset Liability Study which determines the appropriate risk adjusted return profile (or strategic benchmark) for the Fund and through the selection process followed before managers are appointed. This report monitors the return of the strategic benchmark and the performance of the investment managers. An Investment Panel has been established to consider in greater detail investment performance and related matters and report back to the committee on a regular basis.

11 EQUALITIES

11.1 This report is primarily for information and therefore an equalities impact assessment is not necessary.

12 CONSULTATION

12.1 This report is primarily for information and therefore consultation is not necessary.

13 ISSUES TO CONSIDER IN REACHING THE DECISION

13.1 The issues to consider are contained in the report.

14 ADVICE SOUGHT

14.1 The Council's Monitoring Officer (Council Solicitor) and Section 151 Officer (Divisional Director - Finance) have had the opportunity to input to this report and have cleared it for publication.

Contact person	Matt Betts, Asst. Investments Manager (Tel: 01225 395420)
Background papers	Investment manager reports for quarter ending 31 March 2010 LAPPF Member Bulletins Data supplied by The WM Company
Please contact the report author if you need to access this report in an alternative format	

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AVON PENSION FUND VALUATION – 30 JUNE 2010

	Passive Multi-Asset		**Active Equities**			**Enhanced Indexation**		**Active Bonds**	**Funds of Hedge Funds**	**Property**	**In House Cash**	**TOTAL**	**Avon Asset Mix %**
All figures in £m	Black-Rock	Black-Rock 2*	TT Int'l	Jupiter (SRI)	Genesis	Invesco	State Street	Royal London		Schroder Partners			
EQUITIES													
UK	401.0	18.3	106.6	89.3								615.2	26.7%
North America	98.5	10.1										108.6	4.7%
Europe	103.8	6.8					26.2					136.8	5.9%
Japan	33.5	7.2					26.4					67.1	2.9%
Pacific Rim	38.8						23.9					62.7	2.7%
Emerging Markets					123.1							123.1	5.3%
Global ex-UK						140.4						140.4	6.1%
Global inc-UK	128.8											128.8	5.5%
Total Overseas	***403.4***	***24.1***			***123.1***	***140.4***	***76.5***					***767.5***	***33.3%***
Total Equities	**804.4**	**42.4**	**106.6**	**89.3**	**123.1**	**140.4**	**76.5**					**1382.7**	**60.0%**
BONDS													
Index Linked Gilts	151.5											151.5	6.6%
Conventional Gilts	143.6	52.6										196.2	8.5%
Sterling Corporate	3.6							124.5				128.1	5.6%
Overseas Bonds	74.3											74.3	3.2%
Total Bonds	**373.0**	**52.6**						**124.5**				550.1	**23.9%**
Hedge Funds									208.7			208.7	9.1%
Property										112.6		112.6	4.8%
Cash	3.5	25.3	1.7	2.3						1.3	16.7	50.8	2.2%
TOTAL	**1180.9**	**120.3**	**108.3**	**91.6**	**123.1**	**140.4**	**76.5**	**124.5**	**208.7**	**113.9**	**16.7**	**2304.9**	**100.0%**

N.B. (i) Valued at BID (where appropriate)
(ii) In-house cash = short term deposits at NatWest managed on our behalf by B&NES plus general cash held at Custodian
(iii) BlackRock 2 * = represents the assets to be invested in property, temporarily managed by BlackRock

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Review
for period to 30 June 2010

Avon Pension Fund

JLT BENEFIT SOLUTIONS

Avon Pension Fund

Contents

Bekki Jones, BSc (Hons), IMC
Investment Consultancy Analyst

Dave Lyons, BA (Hons), IMC
Divisional Director

August 2010

Section One - Executive Summary

- This report is produced by JLT Benefit Solutions to assess the performance and risks of the investment managers of the Avon Pension Fund (the "Fund"), and of the Fund as a whole.

Highlights

- The total Fund's assets fell in value by £149m over the second quarter of 2010, to £2,305m as at the end of June 2010.
- Over the last quarter the total Fund's assets produced a negative absolute investment return of -6.1%, outperforming the customised benchmark by 0.1%. Over the last year, the Fund produced a return of 18.6%, which was ahead of the customised benchmark return of 18.4%. Over 3 years, the Fund has produced a return of 0.1% p.a., underperforming the customised benchmark by 0.9% p.a.
- The absolute performance over the quarter was driven by the majority of managers producing negative absolute returns, in particular the equity and hedge fund managers. The returns from the equity funds were the most disappointing, as equity markets were unsettled by fears of a double dip recession. The assets invested in bonds and property produced positive absolute returns.
- Over the year performance remains positive, however the one year return has reduced following the negative return witnessed over the last quarter.
- The small relative outperformance over the quarter resulted from the outperformance of a number of the managers, in particular Jupiter, Genesis, SSgA (Europe and Pacific Rim) and Schroder. The assets with BlackRock, Invesco and RLAM performed broadly in line with their benchmarks. The overall outperformance was achieved despite underperformance from TT, Gottex, Lyster Watson, MAN, Signet, Stenham and Partners.
- There were no significant changes to the Fund's asset allocation during the quarter besides those driven by market movements.
- In May 2010 Jupiter successfully listed on the London Stock Exchange, valuing the firm at £755million.
- In May 2010 GLG Partners announced that it had agreed to be acquired by Man Group plc, through a cash and share exchange, subject to Board and regulatory approval. Shareholders are now invited to vote on the proposal with the outcome of the vote expected 1 September 2010. The acquisition is expected to complete in September 2010. Further news also emerged over the quarter when it was announced that Luke Ellis, a managing director at fund of funds firm Financial Risk Management ("FRM"), also a non-executive chairman of GLG Partners, will join Man Group plc when the proposed acquisition of GLG by MAN either closes or terminates.

Conclusion

- **Strategic allocation:** The Fund's strategic allocation remains well diversified in terms of asset class and regional exposure. We have identified no causes for concern with this strategy outside of the areas that are currently being discussed and progressed by the Investment Panel. We note that the Invitation to Tender stage of the Fund's search for a global equity investment manager closed on 11 August 2010, and the assessment of submissions received is currently underway.
- **Manager Performance:** We have identified no areas of significant concern regarding the managers. However, we note that the SRI constraints on Jupiter may be at the cost of continued underperformance relative to the benchmark (notwithstanding that their performance over the last quarter has been very strong in relative terms) and continued volatility from this investment. This links in to wider considerations regarding the Fund’s approach to Socially Responsible Investment which will be reviewed in the near future. The continued underperformance of MAN, although not of significant magnitude on a quarterly basis, should be considered when the fund of hedge fund investments are reviewed later this year. Besides these concerns, we see no reason not to invest with any of the active managers during any rebalancing process, although given that the SRI policy is to be reviewed, this would imply that no new investment should be made with Jupiter until firmer conclusions have been drawn as to future policy.
- While we have no immediate concerns over the changes to Jupiter and proposed changes to MAN's ownership structures and the impact on the management of the funds, we recommend that further investment is not made into these funds until the impact of these changes is clear.

Section Two – Market Background

- The tables below summarise the various market returns to 30 June 2010, which relate the analysis of the Fund's performance to the global economic and market background.

Market statistics

Market Returns Growth Assets	3 Mths %	1 Year %
UK Equities	-11.8	21.1
Overseas Equities	-10.5	24.1
USA	-10.4	26.0
Europe	-14.2	17.0
Japan	-8.7	10.5
Asia Pacific (ex Japan)	-6.9	34.6
Emerging Markets	-6.5	37.7
Property	3.6	23.9
Hedge Funds	-2.3	11.6
Commodities	-9.2	4.1
High Yield	-0.7	38.9
Cash	0.1	0.5

Market Returns Bond Assets	3 Mths %	1 Year %
UK Gilts (>15 yrs)	6.4	8.0
Index-Linked Gilts (>5 yrs)	1.6	8.4
Corporate Bonds (>15 yrs AA)	3.6	17.3
Non-Gilts (>15 yrs)	3.1	17.6
Inflation Indices	**3 Mths %**	**1 Year %**
Price Inflation (RPI)	1.5	5.0
Earnings Inflation	-1.9	1.9
Consumer Price Index (CPI)		

Change in Sterling	3 Mths %	1 Year %
Against US Dollar	-1.4	-9.2
Against Euro	9.0	4.0
Against Yen	-6.6	-16.7
Yields as at 30 June 2010	**% p.a.**	
UK Equities	3.34	
UK Gilts (>15 yrs)	4.14	
Real Yield (>5 yrs ILG)	0.67	
Corporate Bonds (>15 yrs AA)	5.31	
Non-Gilts (>15 yrs)	5.40	
Absolute Change in Yields	**3 Mths**	**1 Year**
UK Gilts (>15 yrs)	-0.3	-0.2
Index-Linked Gilts (>5 yrs)	0.0	-0.2
Corporate Bonds (>15 yrs AA)	-0.2	-0.9
Non-Gilts (>15 yrs)	-0.2	-0.8

Statistical highlights

- In the UK, the General Election resulted in a hung parliament and the formation of a coalition government. The new government has quickly taken action to allay concerns about the high budget deficit and, in the emergency budget, increased VAT, imposed a levy on banks and announced that most government departments would have to reduce spending by 25% by 2014/15.
- Short term factors, such as the restoration of the standard rate of VAT to 17.5%, higher oil prices and the past depreciation of sterling have led to a rise in the rate of RPI inflation to 5%.

- The crisis of confidence in the Eurozone sovereign debt markets has led to a significant rise in the spread between yields on most government bonds within the region and German bunds, and, over the quarter, the rating agencies downgraded Greece, Spain and Portugal. With uncertainty as to how the Eurozone problems would be solved, the government bond markets in the UK and the United States both benefited from a 'flight to quality'.
- Against this background, global equity markets performed poorly over the quarter on concerns that the imposition of austerity measures in Europe and a slowdown in the pace of economic recovery in the US could lead to a double dip recession.
- Over the quarter, sterling strengthened against the euro owing to the crisis of confidence in the single currency, although sterling depreciated against the US dollar and the Japanese yen.

UK market events – Q2 2010

- **Quantitative Easing:** The Bank of England has kept its £200 billion quantitative easing programme on hold.
- **General Election:** The results of the General Election in May gave the nation's first hung parliament since February 1974. The Conservative Party led by David Cameron won the largest amount votes and seats, however this was still short of an outright majority win. Following this, the Conservative party joined forces with the Liberal Democrat Party led by Nick Clegg; forming a coalition government (something which had not been seen in the UK for over 60 years). David Cameron promptly named his cabinet and the newly appoint Chancellor of the Exchequer, George Osborne, announced the 2010 Budget on 22 June 2010 which contained severe fiscal tightening.
- **Government Debt:** In mid August 2010 (latest available) UK national debt stood at £939 billion, or 63.7% of GDP.
- **Unemployment:** The unemployment rate in the UK fell by 49,000 to 2.46 million during the three months to June 2010. The rate of unemployment fell by 0.2% to 7.8%, according to the Office for National Statistics. This was the second month in succession where the jobless number has fallen and is the biggest such drop in three years. The number of people employed increased by 184,000, the largest quarterly rise since 1989.
- **Manufacturing Sector:** The Purchasing Managers' Index ("PMI") manufacturing survey fell from 54.6 in March 2010 to 54.4 in June 2010 (the 50-level being the point at which 'contraction' is deemed to become 'growth').
- **Inflation:** CPI annual inflation fell from 3.4% at the start of the quarter to 3.2% at the end of June 2010. RPI annual inflation rose from 4.4% at the start of the quarter, to 5.0% at the end (RPIX inflation, which excludes mortgage interest payments remains unchanged at 5.0%). The equivalent annualised EU CPI figure was 1.9%. The Governor of the Bank of England, Mervyn King, was forced to write a letter to the Chancellor of the Exchequer, George Osbourne, explaining why the CPI was more than one percentage point above the 2% target, warning he would write similar letters in the short term as prices are expected to continue to rise. Short term factors, such as the restoration of the standard rate of VAT to 17.5%, higher oil prices and the past depreciation of sterling have led to a rise in the rate of inflation.
- **Gross Domestic Product:** In the second quarter of 2010 GDP grew by 1.1%, compared with (an adjusted) 0.3% in the previous quarter. This is the third successive quarter of economic expansion, which was mainly attributed to growth across the board for example in services, construction and production. Manufacturing made the largest contribution to the growth, where output rose 1.6%.

- **Interest Rate:** Despite the fact inflation remains well above the Bank of England's target of 2.0%, the Bank's Monetary Policy Committee maintained interest rates at a record low of 0.5%, which has been in place since March 2009. The economic recovery continued in the UK, with output growth across the first half of 2010, close to historical levels. However, the level of economic activity remained well below its pre-crisis peak and the revival of the economy remains fragile with significant downside risks and spare capacity is likely to persist. Economists have largely welcomed the Bank of England's decision arguing low interest rates are needed to aid the recovery in the economy, particularly with cuts in public sector spending expected to have a detrimental effect on growth prospects.

Europe market events – Q2 2010

- **European sovereign debt crisis:** The European sovereign debt crisis dominated markets, with the strength of the euro falling against major currencies. Investors become increasingly risk averse leading to a large scale sell-off of southern European government bonds in a so-called 'flight to quality', with investors switching to (perceived safer) German and UK government bonds. As a result bond yields fell for German and UK government bonds and rose for the so-called "Club Med", Southern European countries of Greece, Italy, Spain and Portugal.
- **Greece:** The Greek economy remains deep in economic crisis after being forced to adopt harsh austerity measures to reduce the national debt. Public spending has been severely cut and the government has raised the level of taxation in an effort to halt the country's rising budget deficit. The Greek economy shrank by 1.5% in the second quarter and unemployment increased to 12%, pointing to a deep recession as the country battles its debt crisis. The disappointing official GDP figures have increased the cost of protecting Greek government debt against default. The cost of insuring exposure to €10m of Greek government bonds now stands at €795,000 a year, according to CDS monitor Markit.
- **Spain:** The Spanish economy remains fragile against a backdrop of volatile financial markets and an acute crisis of confidence, following the spread of the effects of the Greek fiscal crisis to other European economies. GDP rose by 0.2% during the second quarter despite the Spanish government's austerity measures designed to reduce the national debt. Unemployment rose to a decade high of 20.1% and there are fears the economy will slip back into recession as fiscal tightening implies the economy will have to fend for itself.
- **Germany:** The German economy expanded at its fastest pace in nearly 20 years during the second quarter, which saw a 2.2% expansion with the economy showing signs of improvement where the services and industrial sectors provided strong return figures and the stress test results in the banking sector largely restored confidence in markets.
- **Unemployment:** Unemployment in the EU 27 remained at 9.6% over the second quarter. The lowest unemployment levels were in Austria (3.9%) and the Netherlands (4.4%), and the highest in Latvia (20.0% estimated) and Spain (20.0%).
- **Services and Manufacturing Sectors:** The Eurozone's services sector PMI expanded over the 3 months in the second quarter of 2010 to 56.0 in June 2010 (again, the 50-level separating growth from contraction), and continued to rise to 56.7 in July 2010. Manufacturing output has shown signs of improving with the PMI increasing to 55.6 in June 2010.
- **Inflation:** Annual inflation in the Eurozone remained unchanged at 1.4% in June 2010.
- **Gross Domestic Product:** GDP increased by 1.0% in both the Eurozone and the EU 27 during the first quarter of 2010.

- **Interest Rate:** The European Central Bank has maintained its decision to keep the base rate at a record low of 1.0% since May 2009.

US market events – Q2 2010

- **Unemployment:** The rate of unemployment in the US rose from 9.3% in May 2010 to 9.6% in June 2010.
- **Manufacturing and Industrial Production:** The growth in manufacturing production fell over Q2 2010, leading commentators to suggest production could actually tip into negative territory.
- **Inflation:** The Consumer Price Index annual change fell to 1.1% p.a. in June 2010 from 2.3% p.a. as at 31 March 2010. The weak global outlook dampened inflation expectations, with recent economic data suggesting growth in the US economy was stuttering, with investors switching to so-called safe heaven assets such as government bonds.
- **Gross Domestic Product:** US GDP increased by 2.4% over the second quarter of 2010, which has slowed from the previous quarter.
- **Interest Rate:** The Federal Reserve continues to hold interest rates at 0.25%.
- **US Housing Market:** Sales of existing homes in the US have plunged to their lowest level in more than 10 years, caused by the end of tax credits for home buyers hitting the housing market. The figures have added to fears about the US economic recovery.

Emerging Markets market events – Q2 2010

- Emerging Markets produced negative returns over the second quarter of 2010. However, the Chinese economy only produced a return of -2.5% and India achieved a slight positive return of 0.2%. Emerging Markets are seen by many commentators as being the most resilient markets in the face of a potential double-dip recession in the developed Western economies.
- Policy makers in Brazil and China have been fretting about the excessive pace of expansion and in recent months have applied the policy brakes on their economies. Questions remain whether the Emerging Market nations can sustain their recoveries given the economic uncertainties returning to the developed world.

Market events – Global summary – 1 year

- Over the past year the global economy has continued to recover and all the major economies have emerged from recession, with many of the less developed countries growing strongly. Indeed, in China there is speculation of imminent policy tightening to curb inflation, whilst Australia's central bank raised interest rates for the fifth time in seven months in April 2010 to prevent the economy from overheating. However, towards the end of the period, there were signs that the pace of the recovery in both the US and Europe was beginning to slow.

- The sovereign debt crisis affecting mainly the so-called “Club Med” economies and Ireland in the Eurozone has had a major influence on the financial markets over the past few months and has led to fears that the Eurozone economic recovery might stall. As the crisis unfolded in Greece, the Portuguese, Spanish and Irish economies came under the spotlight and the euro depreciated against all the major currencies, with some debate regarding a possible ‘break-up’ of the euro. Initially Germany and France refused to intervene on behalf of Greece, citing the no bail-out clause in the Maastricht Treaty, but market pressures eventually forced the EU, in conjunction with the International Monetary Fund, to provide a €750 bn liquidity package. The package provides a short-term financing facility that enables governments to rollover maturing debt at favourable rates. This reduces the likelihood of a sovereign default, which potentially could lead to a default of a major European bank, many of which have significant exposure to government debt in these countries. Fiscal tightening measures are now being implemented in most Eurozone countries in order to head off a worsening of the debt crisis, although this has led to demonstrations in both Greece and Spain.
- The Bank of England spent £200bn under its policy of quantitative easing (“QE”) by purchasing gilts in order to improve liquidity in the markets and to stimulate the economy. Although the UK economy has emerged from recession, it remains fragile, growing by just 0.3% in the first quarter of 2010, and the newly created Office for Budgetary Responsibility forecasts that the economy will grow by 1.2% in 2009/10 and 2.3% in 2010/11 notwithstanding the figure of 1.1% for GDP growth in Q2 2010.
- In the latter part of 2009 and during the run up to the General Election, there was increasing concern about the spiralling level of government debt and a rapid rise in the rate of both RPI and CPI rates of inflation, albeit from a very low level. In the UK, the prospect of a hung parliament also led to uncertainty in the UK financial markets. The General Election resulted in a hung parliament and the formation of a coalition government. However the new coalition government has quickly taken action to allay concerns about the high budget deficit and, in the emergency budget, increased VAT, imposed a levy on banks and announced that most government departments would have to reduce spending by 25% by 2014/15. Against this background, the Monetary Policy Committee of the Bank of England (MPC) has maintained interest rates at 0.5% throughout the period. Most analysts now believe that interest rates will remain at a lower level for longer than had previously been forecast, despite the recent increase in the rate of inflation. Some analysts still remain concerned that the scale of the cutback in government spending could lead to a double dip recession.
- Interest rates in the US and the Eurozone were also unchanged over the year at 0.25% and 1.0% respectively.

Equities

- Amid increasing evidence that the global economy was emerging from recession, the recovery in the global equity markets from the low point in March 2009 gained momentum during the remainder of the 2009. The markets continued to rally during Q1 2010, but during Q2 2010 they performed poorly as the pace of the economic recoveries in the United States and Europe moderated. Nevertheless, the return on the UK equity market over the year was 21.1% and that on overseas equity markets was 24.1%. During the period, the FTSE All-Share Index rose to a level above that last seen prior to the collapse of Lehman Brothers.
- More recently, the European debt crisis has dominated the headlines, leading to major falls in share prices, particularly those of the Southern European banks. In local currency terms the worst performing equity market over the last quarter was in Japan, which fell by 14.7% but the US, UK, Europe ex UK, Emerging Markets and Asia Pacific fell by 11.6%, 11.8%, 8.2%, 6.0%, and 4.7% respectively.
- The optimism in the UK equity market that had emerged since last June quickly evaporated during Q2 2010 as it emerged that the UK economic recovery was not gaining momentum. The BP oil spill in the Gulf of Mexico dominated the headlines over the quarter and has led to strained relations between the US and UK governments. At one stage, BP comprised almost 7% of the FTSE All-Share Index but its share price has more than halved and, at one stage, it comprised only around 4% of the index. Following pressure from the US government, the company is suspending dividend payments. The impact of the suspension in dividend payments on UK pension schemes is severe, because roughly speaking £1 in every £7 of dividend income from the FTSE 100 companies comes from BP. The disaster has damaged the reputation of BP, is likely to lead to punitive fines and has also had an adverse impact on the valuation of other energy companies.
- Over the period as a whole, the equity markets in the developed and emerging markets of the Pacific Basin produced the best returns as their economies were growing rapidly, their banking systems were not subject to the same pressures as those in the West and there was not a large overhang of government debt.

Bonds & credit

- At the start of the 12 month period, the spread of long-dated AA rated corporate bond yields over long-dated gilt yields stood at approximately 1.9% and over the period it fell to around 1.2%.
- The recovery in the corporate bond market from the low point in March 2009 had begun when it became apparent that investors' worst fears regarding the length and depth of the recession were not being realised and corporate defaults were at a much lower level than had been priced into the market. Despite a high level of new issuance, during the review period there was significant demand from investors as they recognised that corporate bonds offered an equity like long-term rate of return for a much lower level of risk.
- Spreads have widened slightly over the last few weeks because of the flight to quality to gilts rather than any particular concern about corporate bonds and the yields on corporate bonds are still attractive on a longer term view.
- Index-linked gilt yields also fell over the 12 months as fears about the outlook for inflation kept demand at a high level relative to supply.

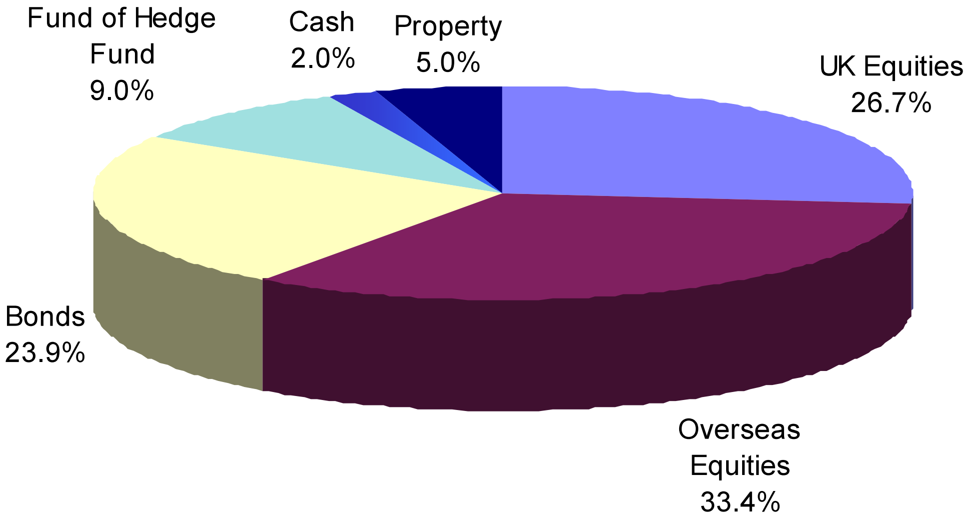
Alternative asset classes

- From mid-2009 onwards, property staged something of a bounce-back as investors began to believe that the market had reached the bottom and started to invest their capital. Indeed, towards the end of 2009 and in early in 2010, high demand for property from retail, institutional and foreign investors caused some pooled funds to close to new investment, or to introduce a waiting period. This is the reverse of the situation observed as recently as late 2007 / 2008, when funds closed in order to manage requests for disinvestments.
- Hedge funds on the whole had a positive year, although they have tended to underperform the equity markets. In some cases this resulted from a decision by some funds to lock in their profits for 2009 rather than continue to be exposed to market movements in the latter part of 2009. Perhaps surprisingly, hedge funds produced a negative return over the last quarter despite the volatility in the financial markets. Distressed debt and long / short equity funds were among the better performing hedge fund strategies over the period.
- For most of the period under review, commodities performed well, benefitting from the strength of the global economic recovery. Although commodity prices fell by more than 9% during the last quarter as the pace of the global recovery slowed, commodities have produced a return of 4.1% over the year.
- Mirroring the events in the corporate bond market, high yield bonds performed strongly with spreads relative to government bonds falling substantially.

Section Three – Fund Valuations

- The chart and table below show the asset allocation of the Fund as at 30 June 2010, with the BlackRock Multi-Asset portfolio and the BlackRock property portfolio (assets "ring fenced" for investment in property) split between the relevant asset classes.

Asset class allocation as at 30 June 2010



Asset Class	30 June 2010 Value £'000	Proportion of Total %	Strategic Benchmark Weight %
UK Equities	615,013	26.7	27.0
Overseas Equities	770,987	33.4	33.0
Bonds	550,230	23.9	20.0
Fund of Hedge Funds	208,668	9.0	10.0
Cash	45,842	2.0	-
Property	114,484	5.0	10.0
Reconciling differences and rounding	-337	0.0	-
TOTAL FUND VALUE	**2,304,887**	**100.0**	**100.0**

Source: Data provided by WM Performance Services

- The value of the Fund's assets fell by £149m over the second quarter of 2010 to £2,305m, mainly as a result of negative absolute investment performance from asset classes such as UK and overseas equities, as well as hedge funds. These assets comprise approximately 69% of the Fund's assets.
- There has been no significant change to the asset allocation, which has largely drifted with investment market movements over the quarter. There were some investments during the quarter, which included the funding of property investments.
- The valuation of the investment with each manager is provided on the following page.

Manager	Asset Class	31 March 2010 Value £'000	31 March 2010 Proportion of Total %	Net New Money £'000	30 June 2010 Value £'000	30 June 2010 Proportion of Total %
Jupiter	UK Equities	94,241	3.8	-	91,647	4.0
TT International	UK Equities	124,756	5.1	-	108,259	4.7
Invesco	Global ex-UK Equities	158,223	6.4	-	140,403	6.1
SSgA	Europe ex-UK Equities and Pacific incl. Japan Equities	86,044	3.5	-	76,444	3.3
Genesis	Emerging Market Equities	130,121	5.3	-	123,064	5.3
Lyster Watson	Fund of Hedge Funds	9,823	0.4	-	9,530	0.4
MAN	Fund of Hedge Funds	95,047	3.9	-	92,143	4.0
Signet	Fund of Hedge Funds	45,279	1.8	-	45,059	2.0
Stenham	Fund of Hedge Funds	11,544	0.5	-	11,225	0.5
Gottex	Fund of Hedge Funds	51,280	2.1	-	50,712	2.2
BlackRock	Passive Multi-asset	1,273,197	51.9	1,300	1,180,980	51.2
BlackRock (property fund)	Equities, Futures, Bonds, Cash (held for property inv)	130,355	5.3	-7,130	120,337	5.2
RLAM	Bonds	122,185	5.0	-	124,456	5.4
Schroder	UK Property	76,786	3.1	1,630	81,125	3.5
Partners	Property	30,116	1.2	5,500	32,825	1.4
Internal Cash	Cash	15,161	0.6	-1,300	16,676	0.7
Rounding		1	0.1	-	2	0.1
TOTAL		**2,454,159**	**100.0**	**-**	**2,304,887**	**100.0**

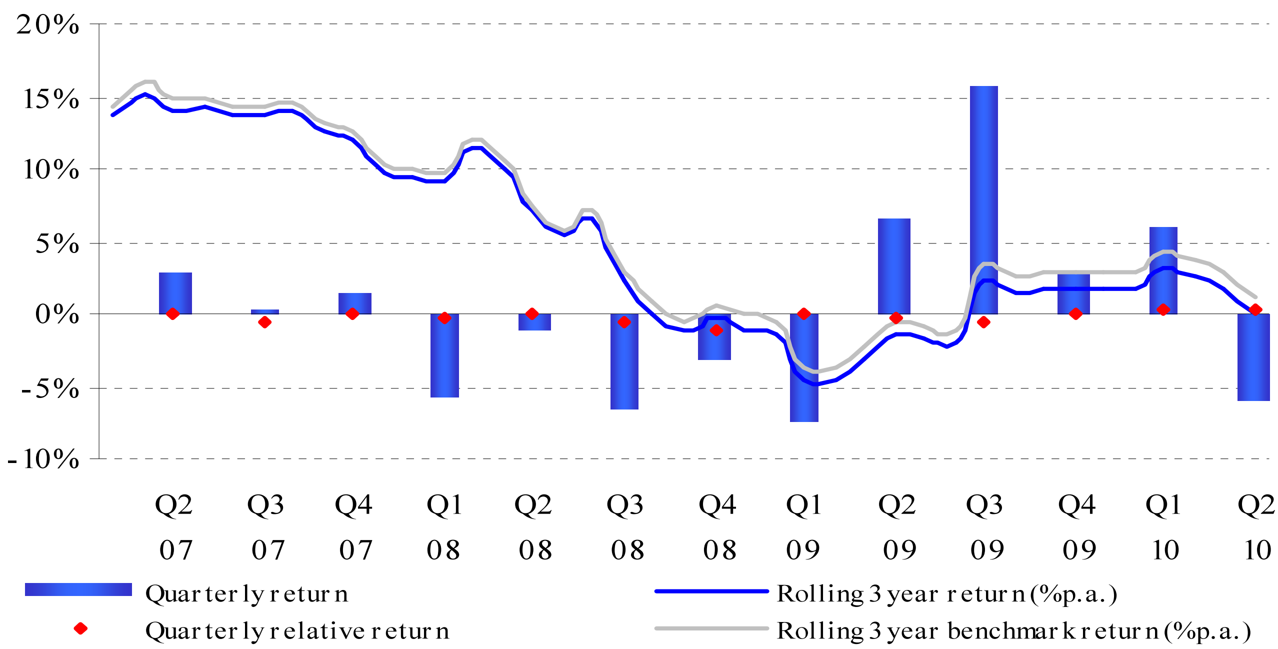
Source: Data provided by WM Performance Services

Section Four – Performance Summary

Total Fund performance

- The chart below shows the absolute performance of the total Fund's assets over the last 3 years.

Total Fund absolute and relative performance



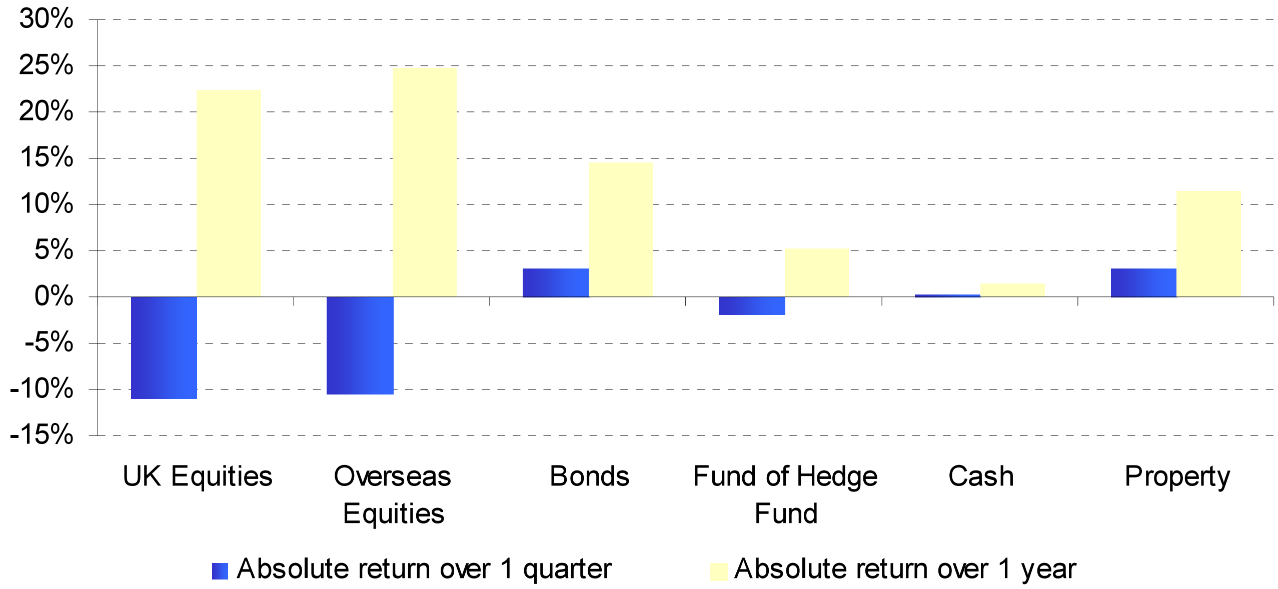
Source: Data provided by WM Performance Services

- Please note that the rolling 3 year return has been included in place of the rolling 1 year returns in previous quarters, to provide a longer term view of investment performance.
- Over the last quarter (blue bars) the total Fund's assets produced a return of -6.1%, outperforming the customised benchmark by 0.1%.
- Over the last year (not shown above) the total Fund's assets produced a positive return of 18.6%, outperforming the customised benchmark by 0.2%.
- Over the last 3 years (blue versus grey line) the total Fund's assets produced a positive return of 0.1% p.a., underperforming the customised benchmark by 0.9% p.a.
- The driver of negative absolute performance over the last quarter was the negative absolute returns from the majority of the Fund's managers across the asset classes (see page 17), in particular those within equities (both UK and overseas) and hedge funds.
- The slight outperformance over the quarter arose from positive relative returns from a number of the managers, most notably Jupiter, Genesis, SSgA and Schroder. BlackRock (multi asset), Invesco and RLAM performed broadly in line with their benchmarks. There were some underperforming managers (namely TT and the hedge fund managers) however these were outweighed by the positive relative returns.

Asset classes performance

- The chart and table below show the absolute performance of the Fund's assets by asset class over the quarter and year to 30 June 2010. Note that the returns from the BGI Multi-Asset portfolio and the second BGI portfolio (now under the name of BlackRock), which hold a combination of asset classes, are aggregated within the relevant asset class returns.

Asset class absolute performance to 30 June 2010



Source: Data provided by WM Performance Services

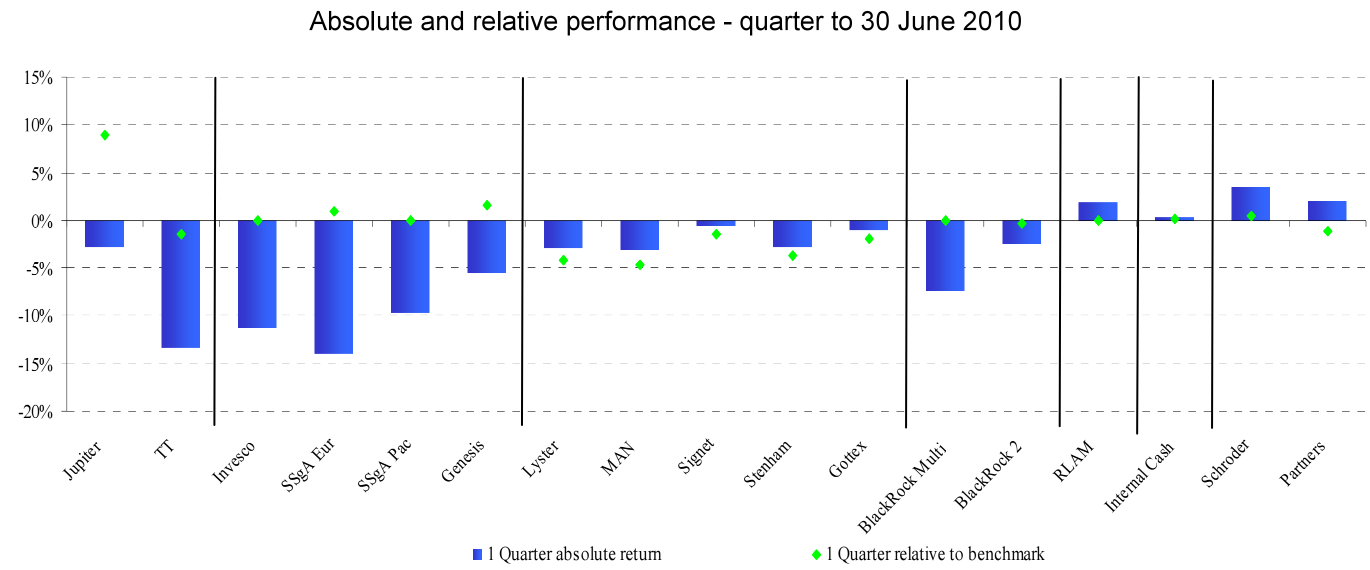
- Over the second quarter of 2010, UK equities, overseas equities and fund of hedge funds all produced negative returns; bonds produced positive returns, as did cash and property, albeit small.
- The key drivers of absolute performance are:
- UK and overseas equity markets had a turbulent quarter and produced disappointing returns of -10.8% and -10.4% respectively.
- Sterling depreciated against the dollar and yen over the quarter, meaning a higher return on the dollar and yen denominated overseas equities in sterling terms. Sterling appreciated against the euro, meaning a lower return on the euro denominated overseas equities in sterling terms. All major markets produced negative returns for the quarter in local currency terms. The highest local currency return came from the Asia Pacific region, and the lowest from the Japan region.
- Bonds produced reasonable returns over the quarter, with the highest bond returns being produced by UK government bonds.
- The fund of hedge fund portfolio produced negative returns of -2.0%.
- The table overleaf shows the returns from major asset class indices over the quarter and year to 30 June 2010:

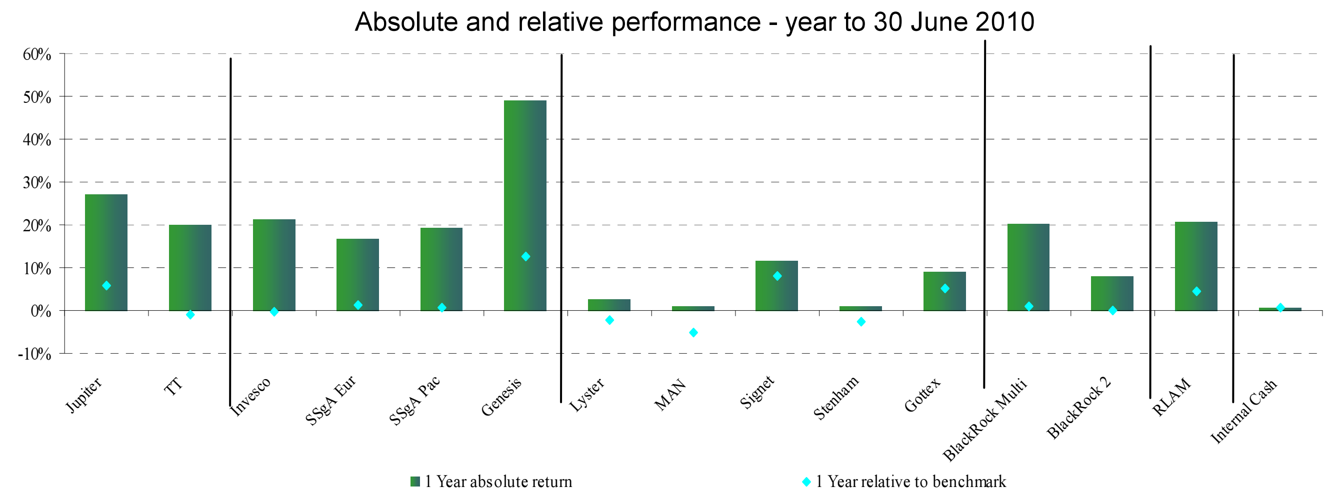
Asset Class	Weight in Strategic Benchmark	Q2 2010 (index returns)	1 year (index returns)
UK Equities	27%	-11.8%	21.1%
Overseas Equities	33%	-10.5%	24.1%
Index Linked Bonds *	6%	1.7%	9.0%
Gov Bonds – Fixed *	14%	4.5%	6.7%
Corporate Bonds *		1.0%	19.0%
Hedge Funds	10%	-2.3%	11.6%
Property	10%	3.6%	23.9%
Total Fund	**100%**		

*Please note that these are 'all maturities' index returns and so differ from the 'long maturities' index returns shown on the Market Background page in Section Two.

Manager performance

- The charts below show the absolute return for each manager over the quarter and the year to the end of June 2010. The relative quarter and one year returns are marked with green and blue dots respectively.





Source: Data provided by WM Performance Services

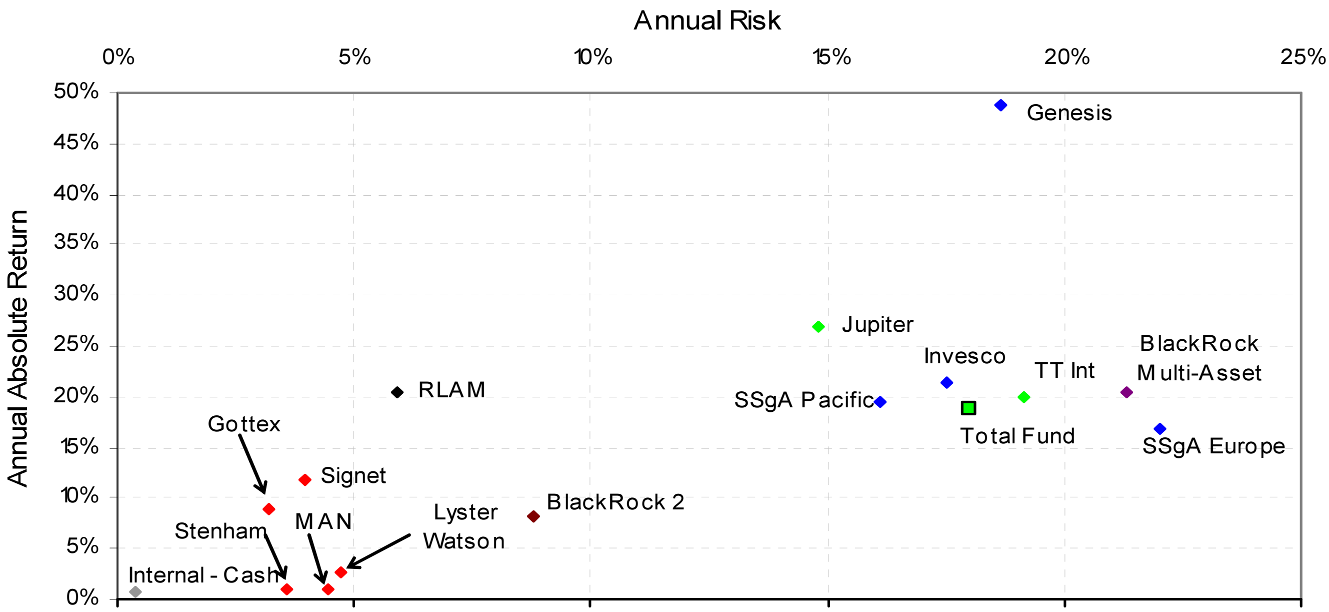
- The Fund invested with Partners for the first time in late Q3 2009 and as such their performance is now shown in the quarterly chart. One year performance data is not yet available for Schroders or Partners.
- Nearly all of the Fund's investment managers produced negative absolute returns over the quarter, the exceptions to this were RLAM, the internally managed cash and the two property funds with Schroder and Partners.
- Over the quarter, the strongest absolute performance came from the Schroder property fund. In relative terms Jupiter performed the best over the quarter, outperforming their benchmark by an impressive 9.1%.

- Over the year, all absolute returns were positive. Of note is the one year return achieved by the Genesis Emerging Markets equity portfolio, which was 48.9%, well ahead of its benchmark return of 36.2%.

Manager and total Fund risk v return

- The chart below shows the 1 year absolute return ("Annual Absolute Return") against the 1 year volatility of absolute returns ("Annual Risk"), based on monthly/quarterly (as available) data points in sterling terms, to the end of June 2010 of each of the funds, along with the total Fund.

1 Year Risk v 1 Year Return to 30 June 2010



Source: Data provided by WM Performance Services

- The managers are colour coded by asset class, as follows:
  - Green: UK equities
  - Blue: overseas equities
  - Red: fund of hedge funds
  - Black: bonds
  - Maroon: multi-asset
  - Brown: BlackRock No. 2 portfolio
  - Grey: internally managed cash
  - Green Square: total Fund
- Note: the property funds have invested for less than 1 year so are not shown in the chart above.
- The volatility of returns over the year has overall risen compared to last quarter. This is unsurprising given the returns which were witnessed over the last quarter. The funds where volatility increased notably compared with last quarter were Invesco, BlackRock Multi-Asset, SSgA Pacific and BlackRock No. 2. Jupiter decreased in volatility over the last quarter. Overall the changes to the volatility in the hedge funds were marginal.

- There has again been a shift downwards in the annual returns compared to last quarter, particularly the equity funds. This was driven by the fact that these funds produced negative returns over the last quarter particularly for the equity funds.
- The returns from the fund of hedge funds are again at a lower level (lower down on chart) than most of the other managers, but at significantly lower volatility (to the extreme left).
- The very strong absolute return from Genesis over the last year has provided a very good risk adjusted absolute return, when compared with its annualised volatility and other funds.
- The volatility of all of the various funds is broadly in line with expectation. The total Fund has benefited from diversification by asset classes, as Fund volatility is lower than the equity managers and the BlackRock multi-asset portfolio, despite these making up a large proportion of the total assets.

Section Five - Manager Performance

- This section provides a one page summary of the key risk and return characteristics for each investment manager. An explanatory summary of each of the charts is included in the Glossary in Appendix A, with a reference for each chart in the chart title (e.g. #1). A summary of mandates is included in Appendix B, which shows the benchmark and outperformance target for each fund.

Summary of conclusions

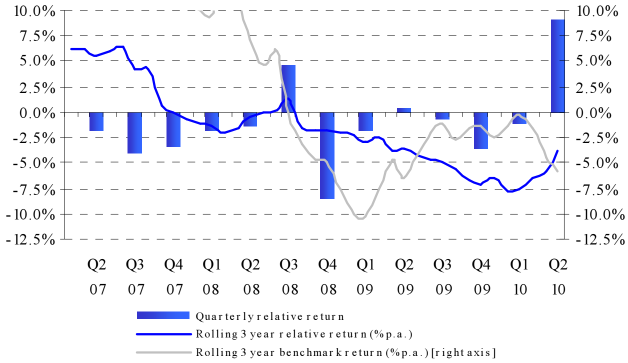
- We have not identified any significant issues with the performance of the active investment managers and have no concerns with investment into any of the active managers for rebalancing purposes. However, we do note that SRI remains under ongoing consideration by the Investment Panel and Committee, which would imply that any new investment with Jupiter should be at least subject to discussion until firm conclusions as to the practical implications of this review are reached.
- UK Equity Funds:
  - Jupiter significantly outperformed over the quarter, with their current SRI restrictions continuing to drive their relative returns, and impacting on the longer term performance. Previously, Jupiter had suffered from their very underweight allocation to the mining and Oil and Gas sectors; these sectors were the worst performers over the quarter, as such this position contributed strongly to the relative returns over the period.
  - In May Jupiter announced that they intended to list on the London Stock Exchange, this took place in June 2010 with the firm being valued at £755million. This will give a cash windfall to existing employees (although they will have lock-in periods). Any cash raised from the initial public offering is expected to be used to pay off debt dating from a private equity backed management buyout in 2007.
  - TT International underperformed their benchmark over the quarter, with the overweight positions in Oil & Gas, and underweights in Telecommunication and Technology detrimental to the relative returns.
- Non-UK Enhanced Indexation Funds: Both SSgA Enhanced Indexation funds produced modest outperformance relative to the benchmarks over the quarter. Invesco performed in line with their benchmark over the quarter, although, as has been noted in previous reports, their performance can be affected by the 'timing' of the pricing of the fund compared to the benchmark index, particularly in more volatile market conditions.
- Emerging Market: Genesis outperformed their benchmark over the quarter, and produced a negative absolute return. The absolute return was driven by equity markets themselves, which overall produced negative returns over the quarter; the relative return was driven by Emerging Market equity returns and stock selection. The latest quarter of outperformance was the fifth consecutive quarter of outperformance from the manager.
- Fund of Hedge Funds:
  - In May GLG Partners announced that it had agreed to be acquired by Man Group plc, through a cash and share exchange. The shareholders are invited to vote on the proposed acquisition, with the results from this expected 1 September 2010. Provided approval is received, the acquisition is due for completion in September 2010.
  - It was announced over the quarter that Luke Ellis, a managing director at fund of funds firm Financial Risk Management ("FRM"), also non-executive Chairman of GLG Partners, will join Man Group plc when the proposed acquisition of GLG by MAN either closes or terminates.
  - Hedge Funds had a difficult quarter, which was driven by market movements; however, Hedge Funds outperformed equity markets.

- All the Hedge Fund managers underperformed their benchmarks this quarter, and all the managers produced negative absolute returns. The best performing manager in both absolute and relative terms was Signet and the bottom performer was MAN.
- Over the year to 30 June 2010, only Signet and Gottex are ahead of their objectives.
- The continued, underperformance of MAN should be considered in conjunction with the further review of the fund of hedge fund investments agreed for the second half of 2010.

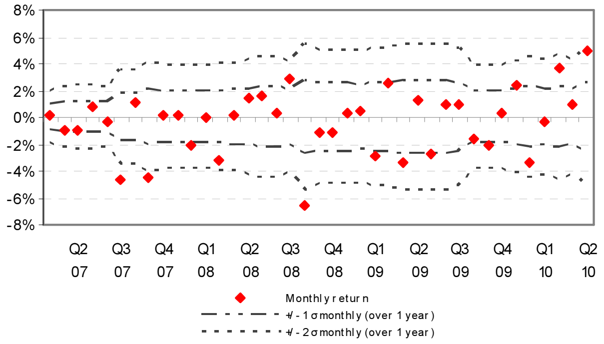
- BlackRock passive Funds: there is nothing unusual arising in risk and performance for the two BlackRock passive funds.
- Fixed Interest: RLAM have performed in line with their benchmark. There are no notable changes in the risk profile of their fund.
- Property: performance of the property funds over the quarter was positive in absolute terms. Schroder outperformed their benchmark, whilst Partners underperformed. Due to the short period since investment in the property funds, details are not provided in the charts following. These will be included in the future, once sufficient performance history is available. For the time being, a qualitative assessment is included for each of these two managers.
- While we have no immediate concerns over the changes to Jupiter and proposed changes to MAN's ownership structures and the impact on the management of the funds, we recommend that further investment is not made into these funds until the impact of these changes is clear.

Jupiter Asset Management – UK Equities (Socially Responsible Investing)

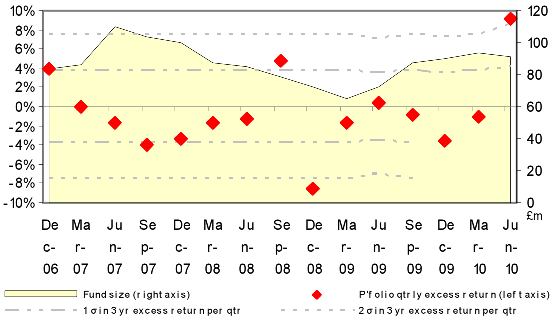
Relative returns #1



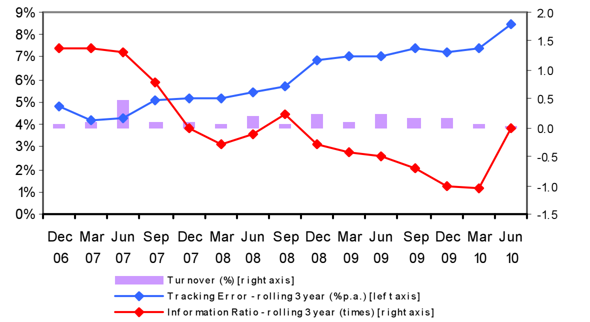
Monthly relative returns #2



Performance v fund size #3



Tracking error, Information ratio, Turnover #4



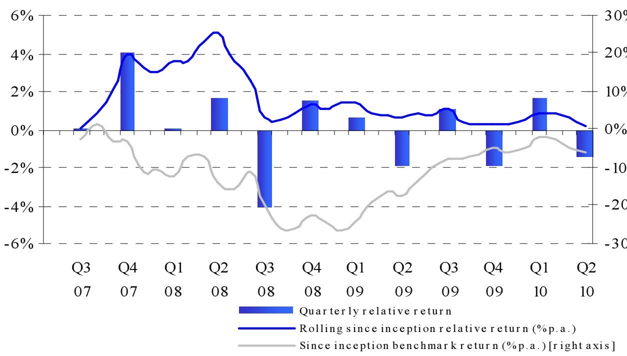
Source: Data provided by WM Performance Services, and Jupiter

Comments:

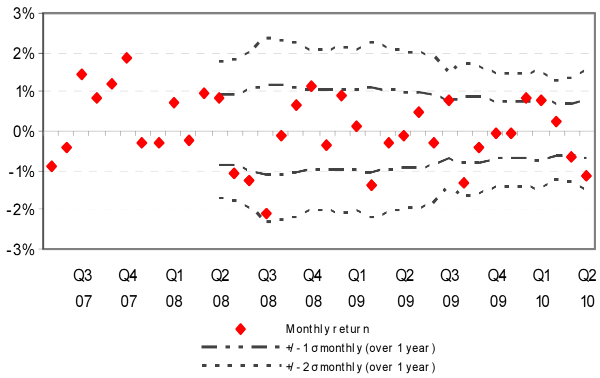
- In May 2010 Jupiter announced that they intended to list on the London Stock Exchange; Jupiter's float went ahead in June 2010, with the company being valued at £755m, whilst this was slightly below the previously targeted value of £1bn, the initial value was within the target range which Jupiter had set (albeit towards the lower end).
- Whilst there can be a risk attached to any significant capital restructuring, it is expected that Jupiter will use the opportunity to grow the business and become a larger and stronger organisation.
- We continue to have no significant concerns over the change, however it may take time before the full impact of the change is known, and therefore we recommend that further investment is not made into this Fund.
- Over the last quarter the Fund outperformed the benchmark by 9.2%, producing an absolute return of -2.7%.
- Over the last year the Fund outperformed the benchmark by 5.8%, producing an absolute return of 27.0%. Over the last 3 years the Fund underperformed the benchmark by 3.8% p.a., producing an absolute return of -9.6% p.a.
- Over the second quarter of 2010, small cap stocks outperformed mid and large cap stocks (-6.1%: -7.1%: -12.6% respectively). The outperformance of small caps benefitted Jupiter's relative performance.
- The Fund has a small exposure to cash (2.6%) which had a positive impact on absolute performance.
- The industry allocation is considerably different from the benchmark allocation (as expected from Socially Responsible Investing), so the variability of relative returns (volatility) is expected to be high. Over Q2 2010, Jupiter were significantly underweight Mining and Oil and Gas, with overweights in Telecommunications and Utilities. These positions, driven by the SRI nature of their mandate, were positive contributors to relative returns.

TT International – UK Equities (Unconstrained)

Relative returns #1

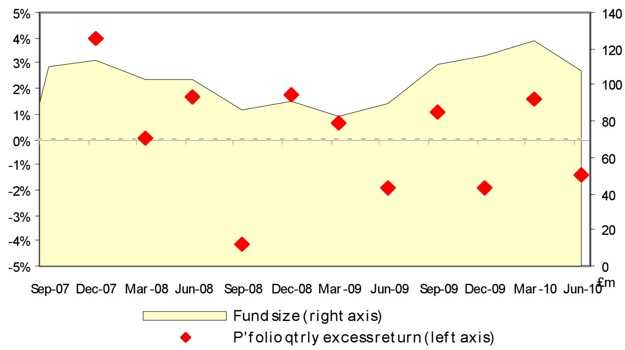


Monthly relative returns #2

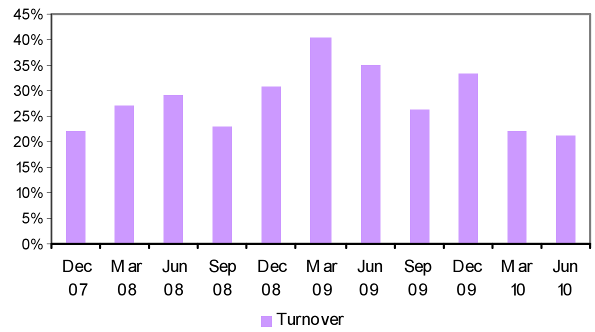


note: Q3 2007 is only a partial period of investment

Performance v fund size #3



Turnover #4

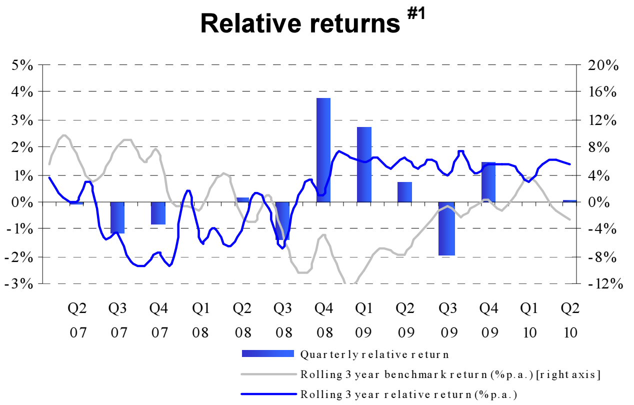


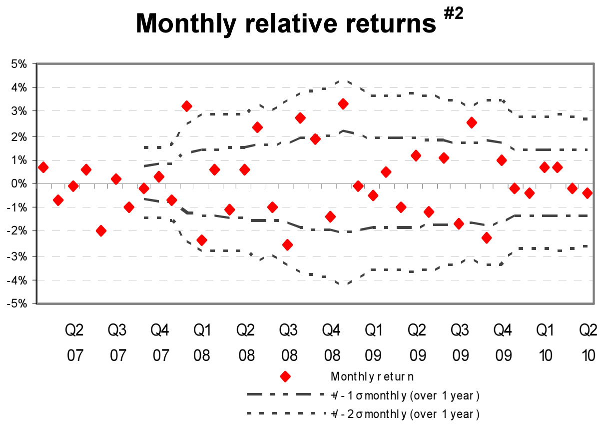
Source: Data provided by WM Performance Services, and TT International

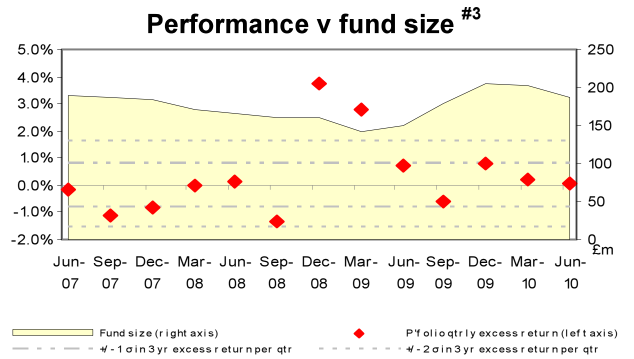
Comments:

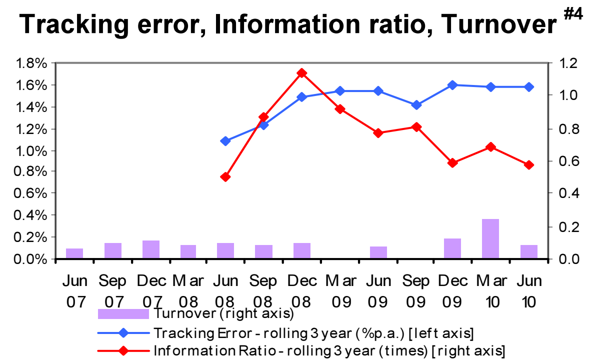
- Over the last quarter the Fund underperformed the benchmark by 1.4%, producing an absolute return of -13.2%.
- Over the last year the Fund underperformed the benchmark by 1.2%, producing an absolute return of 19.9%. Over the period since inception the Fund outperformed the benchmark by 0.2% p.a., producing an absolute return of -5.8% p.a.
- The Fund was overweight in Oil & Gas by 1.7% relative to the benchmark, which was one of the worst performing sectors over the second quarter of 2010. The main underweights, Telecommunication and Technology (3% and 1% respectively) were amongst the strongest performers. These positions were detrimental to performance.
- The volatility of monthly relative returns has not changed significantly over the most recent quarter. Turnover has been marginally lower than in previous quarters, but not significantly so.
- Apart from the particularly poor quarter in Q3 2008, the volatility of this Fund relative to the benchmark is lower than that of Jupiter. This is driven by the fact that TT International's sector positions tend to be less severe than Jupiter's (which are a product of their Socially Responsible Investment brief). This more pragmatic style may be more suited for investment when rebalancing to active UK equities, not least given the ongoing review of SRI and Corporate Governance.

Invesco – Global ex-UK Equities Enhanced (Enhanced Indexation)









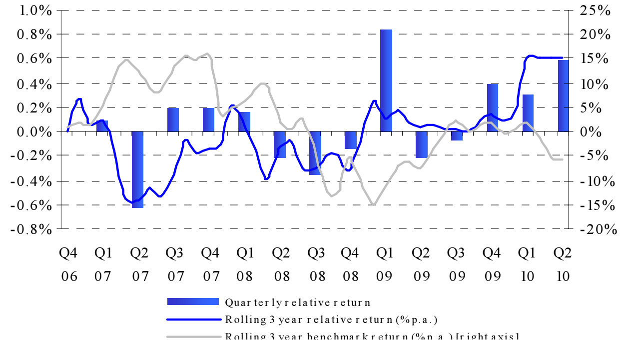
Source: Data provided by WM Performance Services, and Invesco

Comments:

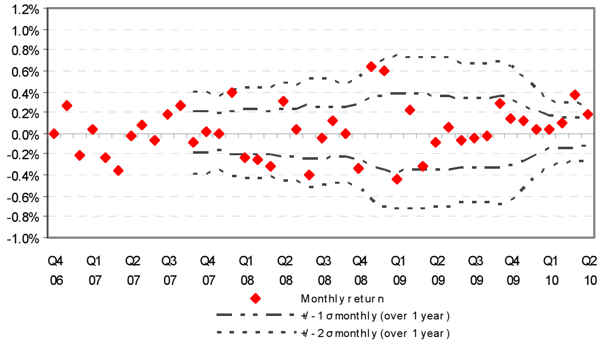
- Over the last quarter the Fund performed in line with its benchmark, producing an absolute return of -11.3%.
- Over the last year the Fund marginally underperformed the benchmark by 0.2%, producing an absolute return of 21.3%. Over three years, the Fund outperformed, by 1.4% p.a., producing an absolute return of -1.2%p.a.
- Contributions to relative performance from stock selection and country selection were broadly neutral. The timing of the pricing of the Fund versus the benchmark also remains a factor in its short term relative performance.
- The volatility of monthly relative returns has reduced gradually over time, as the volatile 2008 has rolled out of the calculations. As an enhanced indexation fund the magnitude of the volatility is quite low. The larger deviations from the benchmark tend to be upwards, which is favourable.
- Turnover decreased slightly over Q2 2010 remaining low, as expected for this mandate. The number of stocks remains at approximately 500, which reduces stock specific risk through diversification.
- The industry allocation is relatively close, with all standard ICB industry sectors within 1.8% of the benchmark allocation, as is to be expected with this mandate.

SSgA - Europe ex-UK Equities (Enhanced Indexation)

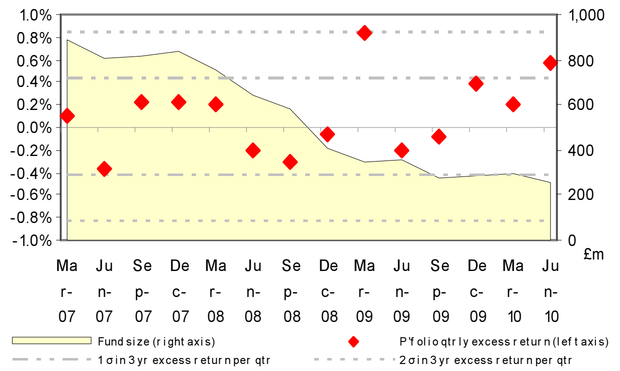
Relative returns [#1]



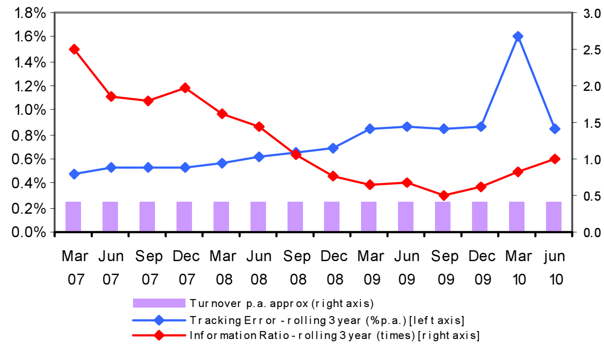
Monthly relative returns [#2]



Performance v fund size [#3]



Tracking error, Information ratio, Turnover [#4]



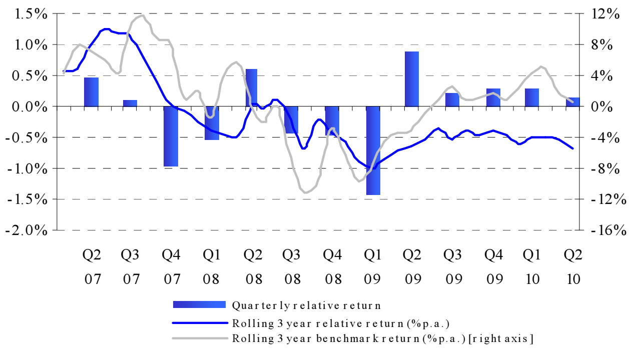
Source: Data provided by WM Performance Services, and SSgA

Comments:

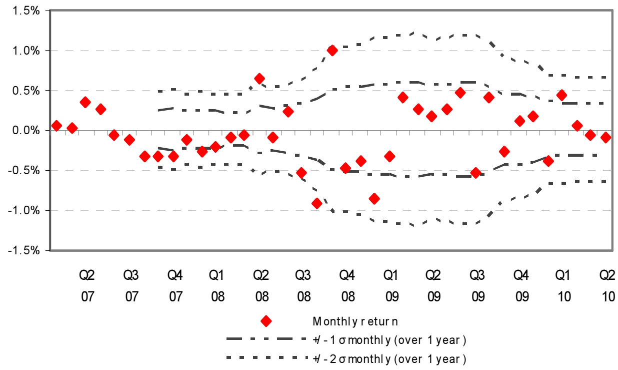
- Over the last quarter the Fund outperformed the benchmark by 0.9%, producing an absolute return of -13.9%.
- Over the last year the Fund outperformed the benchmark by 1.4%, producing an absolute return of 16.7%. Over the last 3 years the Fund outperformed the benchmark by 0.6% p.a., producing an absolute return of -5.0%p.a.
- Stock selection has been the primary driver of relative performance, continuing to account for approximately 90% of relative performance.
- The volatility of monthly relative returns remained fairly constant over the last year. As an enhanced indexation fund the magnitude of the volatility is very low.
- Turnover remains consistent over the last 3 years. The tracking error has decreased over the last quarter back to a similar level as at December 2009.
- Given its reasonable return and low risk this Fund would appear to be suitable for new contributions or suitable for investment if rebalancing is required into active overseas equities subject to the strategic benchmark constraints.

SSgA - Pacific incl. Japan Equities (Enhanced Indexation)

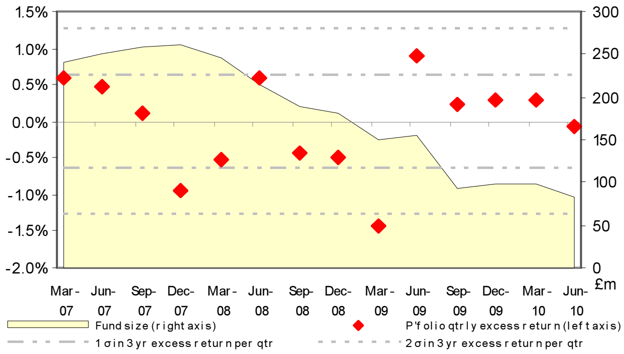
Relative returns #1



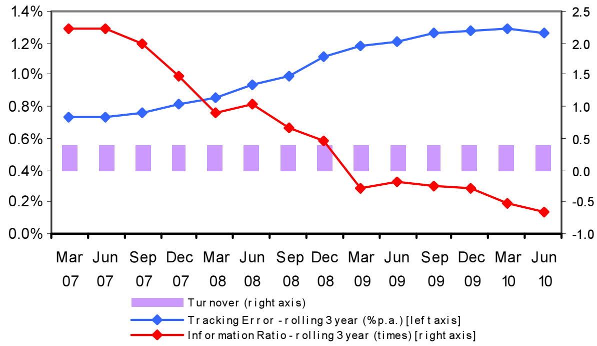
Monthly relative returns #2



Performance v fund size #3



Tracking error, Information ratio, Turnover #4



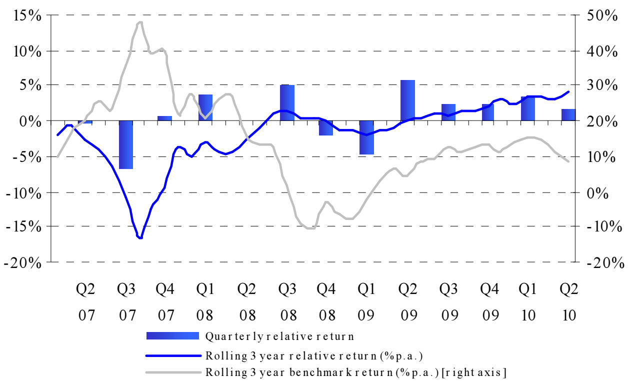
Source: Data provided by WM Performance Services, and SSgA

Comments:

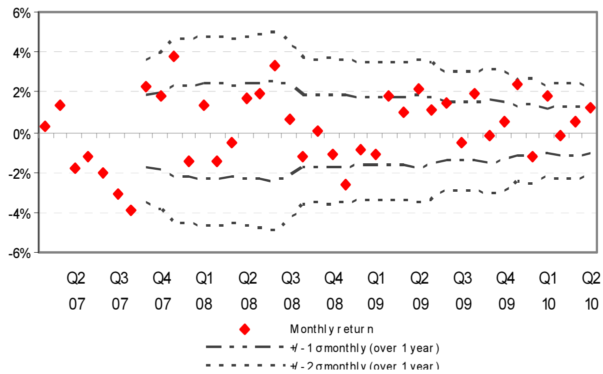
- Over the last quarter the Fund outperformed the benchmark by 0.2%, producing an absolute return of -9.1%.
- Over the last year the Fund outperformed the benchmark by 0.7%, producing an absolute return of 19.4%. Over the last 3 years the Fund underperformed the benchmark by 0.6% p.a., producing an absolute return of 0.0% p.a.
- Similar to the other SSgA portfolio, stock selection has been the primary driver of relative performance over the year, accounting for approximately 90% of relative performance.
- The industry allocation remains close to the benchmark allocation, as would be expected from an enhanced indexation fund.
- Given its reasonable return and low risk this Fund would also appear to be suitable for new contributions or suitable for investment if rebalancing is required.

Genesis Asset Managers – Emerging Market Equities

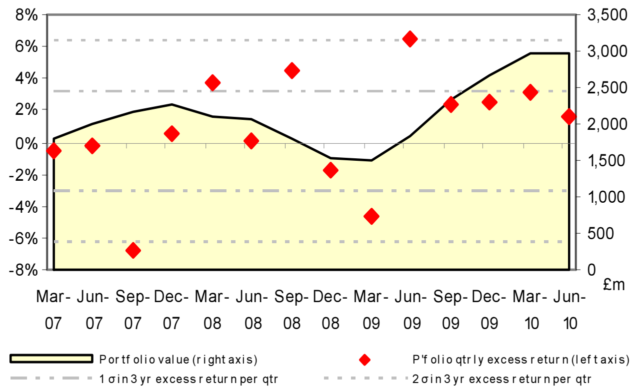
Relative returns #1



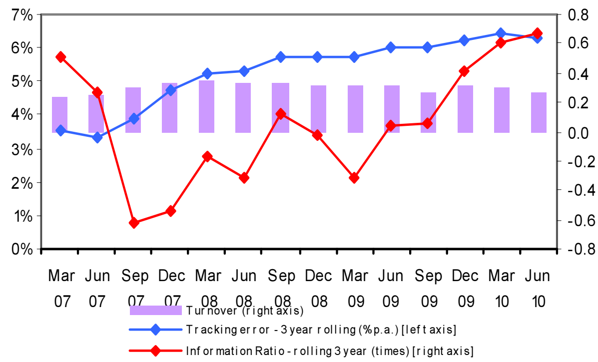
Monthly relative returns #2



Performance v fund size #3



Tracking error, Information ratio, Turnover #4



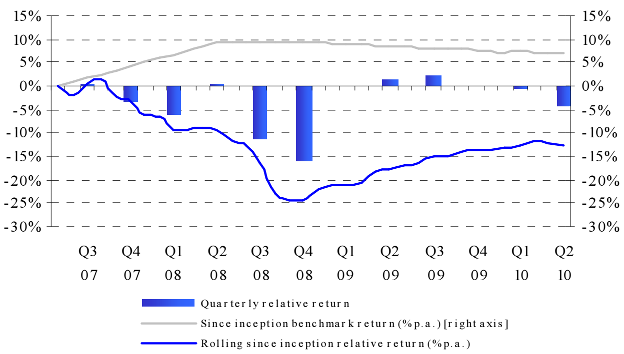
Source: Data provided by WM Performance Services, and Genesis

Comments:

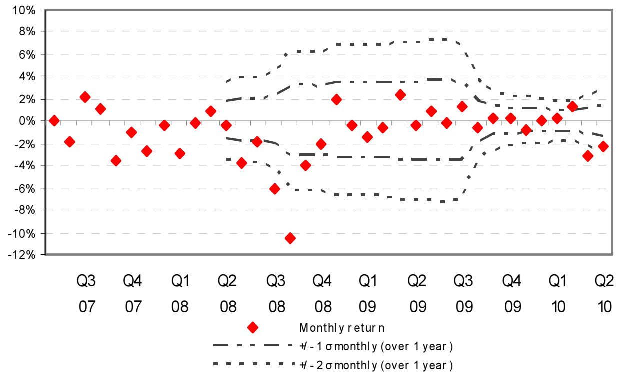
- Over the last quarter the Fund outperformed the benchmark by 1.6%, producing an absolute return of -5.4%.
- Over the last year the Fund outperformed the benchmark by 12.7%, producing an absolute return of 48.9%. Over the last 3 years the Fund outperformed the benchmark by 4.1% p.a., producing an absolute return of 12.5% p.a.
- The Fund is overweight to South Africa, India and Russia, and underweight China and Brazil. Please note that the over and underweights are a result of Genesis' stock picking approach, rather than taking a view on countries. Note that the China underweight is partly due to the restrictions on non-local investors.
- The 3 year tracking error (proxy for risk) fell slightly over the quarter. The 3 year information ratio (risk adjusted return) rose slightly over the quarter.
- On an industry basis, the Fund is overweight in Consumer Staples (+9.4%) and underweight Information Technology (-5.5%) and Energy (-3.8%).

Lyster Watson Management Inc – Fund of Hedge Funds

Relative returns #1

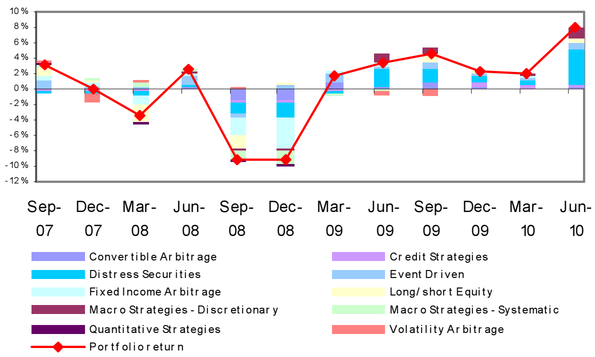


Monthly relative returns #2

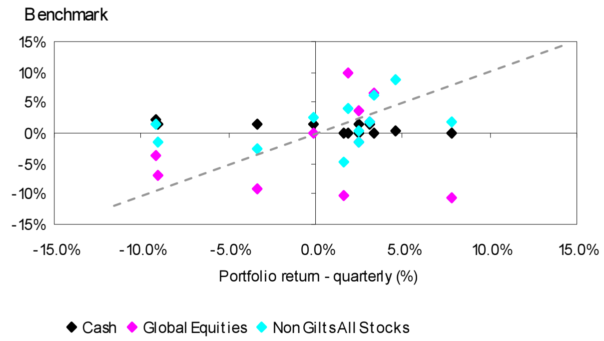


note: Q3 2007 is only a partial period of investment

Hedge fund strategies and source of return #6



Correlation with indices #7



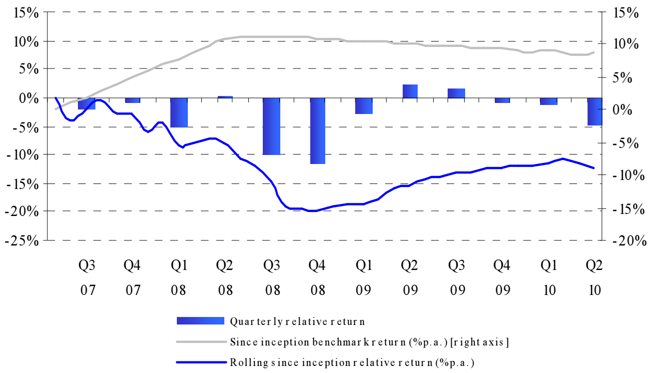
Source: Data provided by WM Performance Services, and Lyster Watson

Comments:

- Over the last quarter the Fund underperformed the benchmark by 4.1%, producing an absolute return of -3.0%.
- Over the last year the Fund underperformed the benchmark by 2.2%, producing an absolute return of 2.5%. Over the period since inception the Fund underperformed the benchmark by 12.8% p.a., producing an absolute return of -5.7% p.a.
- The key driver of the Fund's negative absolute return over the quarter has been the allocation to Distressed Securities, Event Driven Strategies and Long/Short Equity. There were some positive contributions from Credit Strategies and Fixed Income Arbitrage, but these were outweighed by the negative contributors.
- The Fund continues to have a diverse exposure to hedge fund strategies, although there is a continued high allocation of 40% to Distressed Securities and Long/Short Equity strategies.
- There is no clear correlation between this Fund and cash, global equities or non gilt bonds. This suggests that this Fund acts as a good diversifier to the Avon Pension Fund's other asset classes.

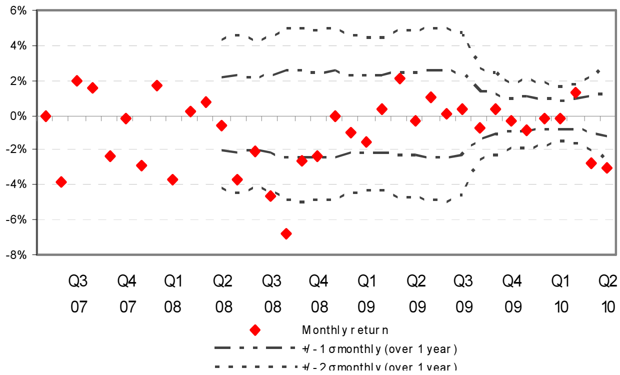
MAN – Fund of Hedge Funds

Relative returns #1

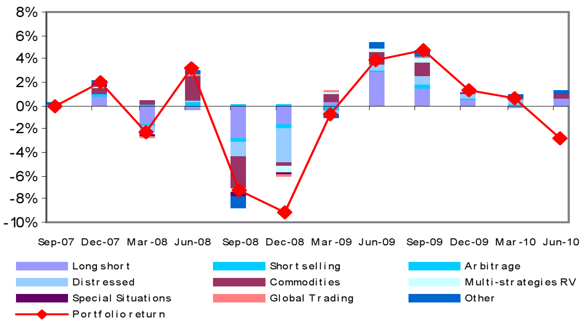


note: Q3 2007 is only a partial period of investment

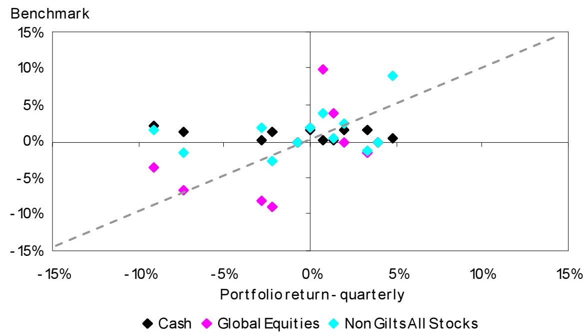
Monthly relative returns #2



Hedge fund strategies and source of return #6



Correlation with indices #7



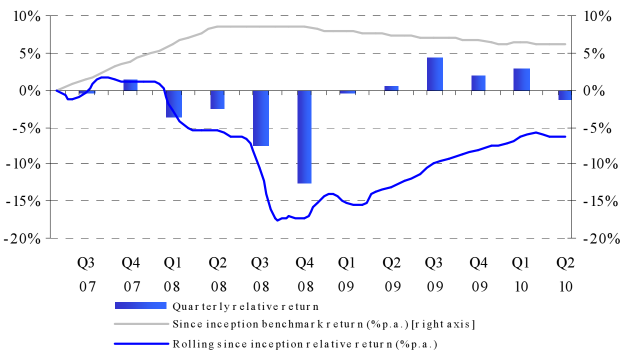
Source: Data provided by WM Performance Services, and MAN

Comments:

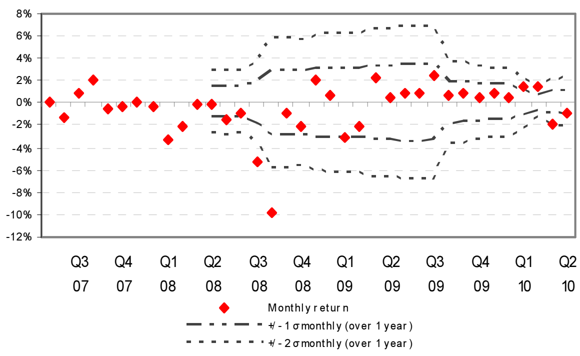
- In May 2010 GLG Partners announced that it had agreed to be acquired by Man Group plc, through a cash and share exchange. Man Shareholders have a meeting scheduled for 1 September, which will allow them to vote on the proposed resolution to approve and implement the acquisition. Provided approval is received, the acquisition is expected to complete in September 2010.
- The merged hedge fund business will manage c.US$63 billion of assets. The acquisition has been stated as the merging of complementary and uncorrelated investment strategies, with significant cost savings identified.
- There are no immediate concerns with the impact on the management of the Fund, although we recommend that further investment is not made into this Fund until the impact of the acquisition is clear.
- Over the last quarter the Fund underperformed the benchmark by 4.7%, producing an absolute return of -3.1%.
- Over the last year the Fund underperformed the benchmark by 5.3%, producing an absolute return of 1.1%. Over the period since inception the Fund underperformed the benchmark by 12.2% p.a., producing an absolute return of -3.3% p.a.
- The key driver of performance was the high allocation to Commodities, Long/Short Asia Pacific and Long/Short, while the remaining strategies produced returns that where either slightly negative or broadly neutral.
- The Fund has a diverse exposure to hedge fund strategies, although 64% is made up of Long/Short and Commodities strategies.
- There is no clear correlation between this Fund and cash, global equities or non gilt bonds. This suggests that this Fund acts as a good diversifier to the Avon Pension Fund's other asset classes.

Signet – Fund of Hedge Funds

Relative returns #1

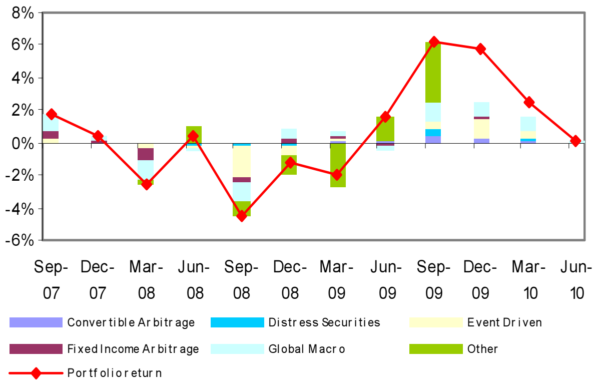


Monthly relative returns #2

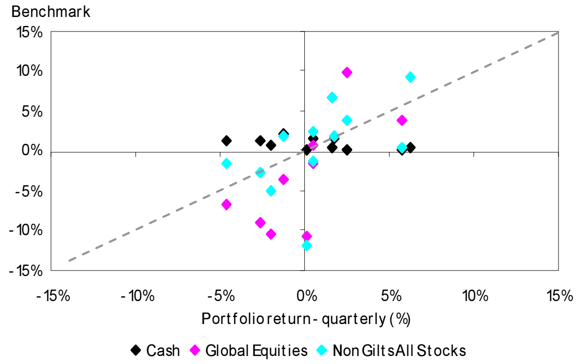


note: Q3 2007 is only a partial period of investment

Hedge fund strategies and source of return #6



Correlation with indices #7

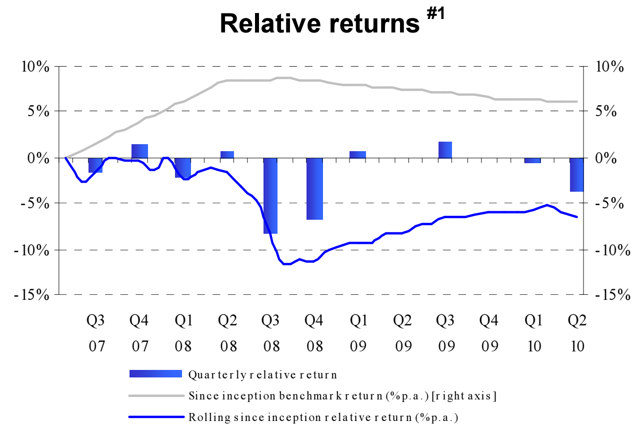


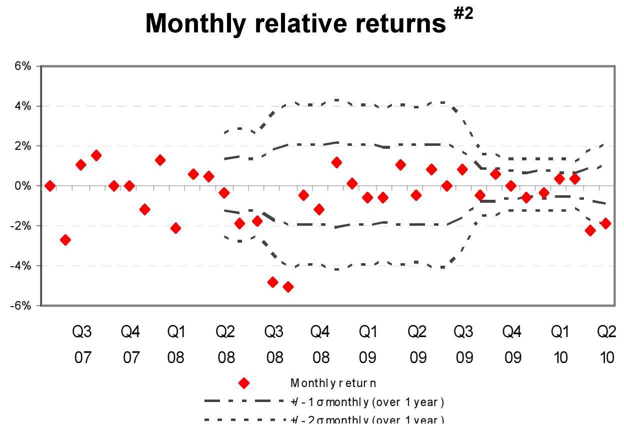
Source: Data provided by WM Performance Services, and Signet

Comments:

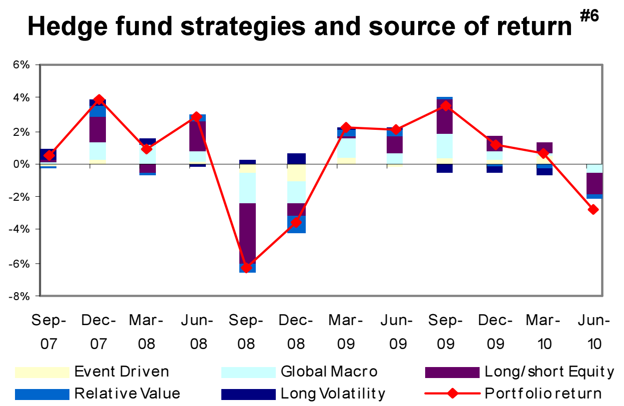
- Over the last quarter the Fund underperformed the benchmark by 1.4%, producing an absolute return of -0.5%.
- Over the last year the Fund outperformed the benchmark by 8.0%, producing an absolute return of 11.7%. Over the period since inception the Fund underperformed the benchmark by 6.4% p.a., producing an absolute return of -0.2% p.a.
- There is no clear correlation between this Fund and cash, global equities or non gilt bonds. This suggests that this Fund acts as a good diversifier to the Avon Pension Fund's other asset classes.

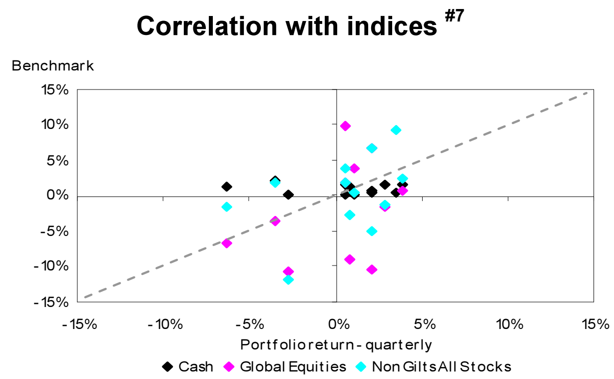
Stenham – Fund of Hedge Funds





note: Q3 2007 is only a partial period of investment





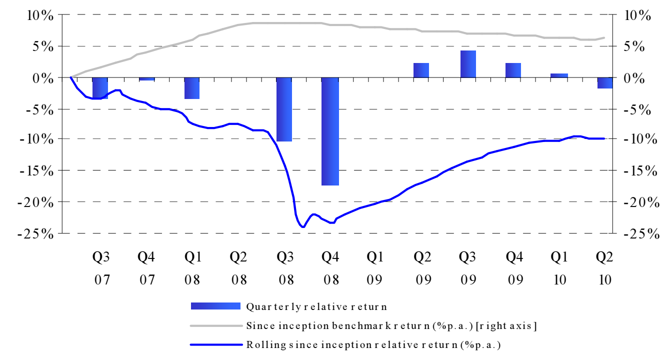
Source: Data provided by WM Performance Services, and Stenham

Comments:

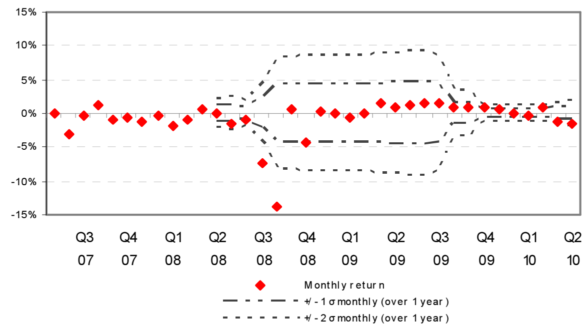
- Over the last quarter the Fund underperformed the benchmark by 3.7%, producing an absolute return of -2.8%.
- Over the last year the Fund underperformed the benchmark by 2.8%, producing an absolute return of 1.0%. Over the period since inception the Fund underperformed the benchmark by 6.4% p.a., producing an absolute return of -0.2% p.a.
- The main contributor to the negative absolute performance was the Long/Short Equity, however all the underlying strategies produced negative absolute returns.
- The allocation to the Global Macro and Long/Short Equity strategies made up 71% of the total Fund allocation. The allocation to cash was increased from 2% to 7.5% over the quarter.
- There is no clear correlation between this Fund and cash, global equities or non gilt bonds. This suggests that this Fund acts as a good diversifier to the Avon Pension Fund's other asset classes.

Gottex – Fund of Hedge Funds

Relative returns #1

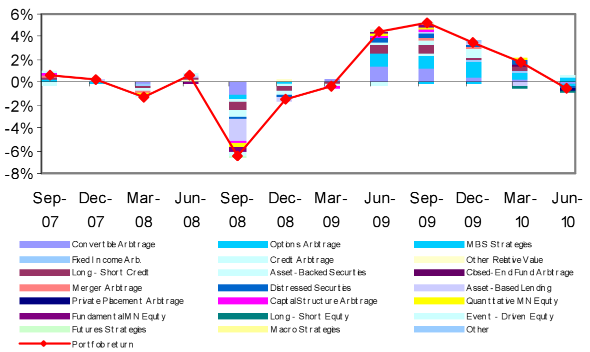


Monthly relative returns #2

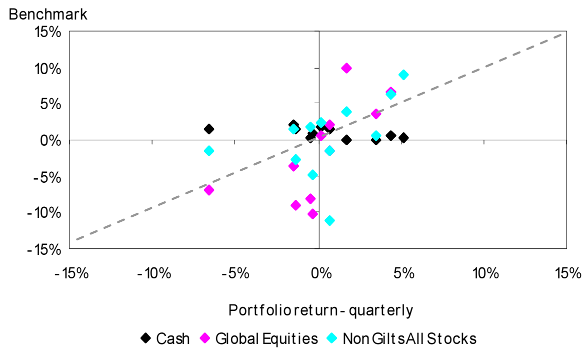


note: Q3 2007 is only a partial period of investment

Hedge fund strategies and source of return #6



Correlation with indices #7



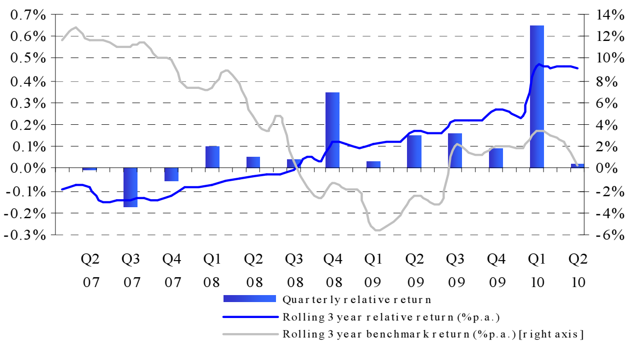
Source: Data provided by WM Performance Services, and Gottex

Comments:

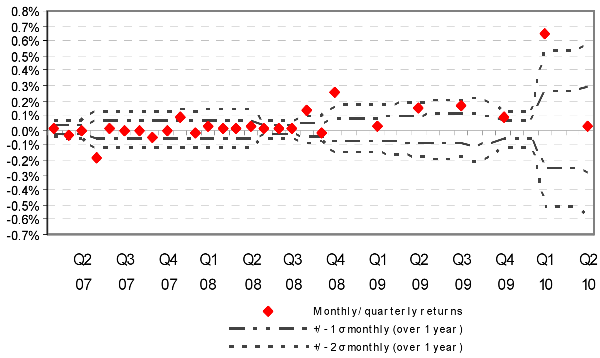
- Over the last quarter the Fund underperformed the benchmark by 1.8%, producing an absolute return of -0.9%.
- Over the last year the Fund outperformed the benchmark by 5.3%, producing an absolute return of 9.0%. Over the period since inception the Fund underperformed the benchmark by 9.9% p.a., producing an absolute return of -3.7%p.a.
- The key drivers of performance were Mortgage Backed Securities ("MBS"), Asset Backed Securities ("ABS"), Options Arbitrage, Asset Based Lending and Asset Based Securities. The largest contributor to performance was from MBS.
- The Fund has a diverse range of strategy exposures, with the major exposures continuing to be Convertible Arbitrage, Long-Short Credit and ABS Strategies.
- There is no clear correlation between this Fund and cash, global equities or non gilt bonds. This suggests that this Fund acts as a good diversifier to the Avon Pension Fund's other asset classes.

BlackRock - Passive Multi-Asset

Relative returns #1

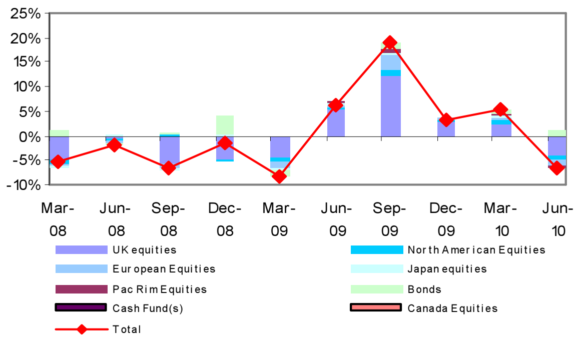


Monthly/Quarterly relative returns #2

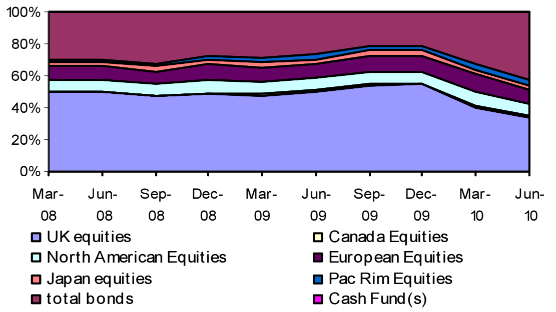


Note that return after Q4 2008 above are quarterly returns.

*Contribution to absolute return #6



Asset Allocation #5



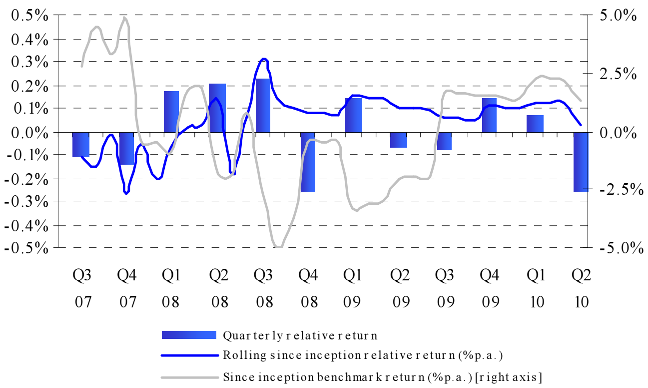
Source: Data provided by WM Performance Services, and BlackRock

Comments:

- Over the last quarter the Fund very marginally outperformed benchmark (by <0.1%), producing an absolute return of -7.4%.
- Over the last year the Fund outperformed the benchmark by 1.0%, producing an absolute return of 20.3%. Over the last 3 years the Fund outperformed the benchmark by 0.5% p.a., producing an absolute return of 0.8% p.a.
- Being a passive mandate, with a customised benchmark based on the monthly mean fund weights, there is nothing unusual arising in risk and performance.
- The portfolio has outperformed its benchmark for the last 10 consecutive quarters, though being passively managed the outperformance has been marginal. This is positive as it indicates minimal relative risk in the portfolio.
- The magnitude of the relative volatility in the portfolio is very small.
- Over the last quarter, and the start position 1 year ago, there has been some change within the underlying asset allocation; the total allocation to bonds has increased and the allocation to equities has reduced, although over the latest quarter in particular this was largely driven by market movements rather than a strategic change.

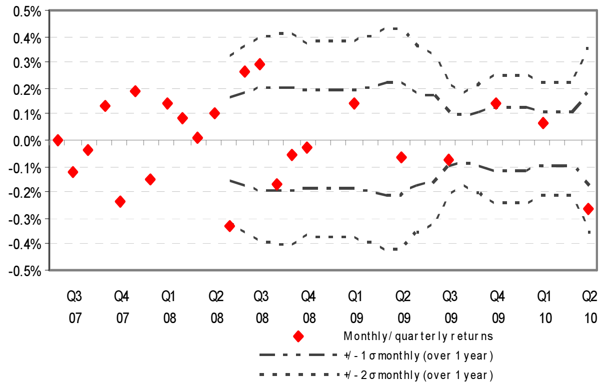
BlackRock No.2 – Property account (“ring fenced” assets)

Relative returns [#1]



Note: Q3 2007 is only a partial period of investment

Monthly relative returns [#2]



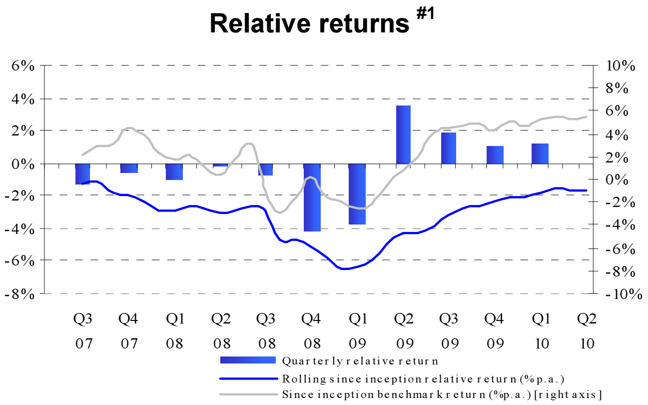
Note that return after Q4 2008 above are quarterly returns.

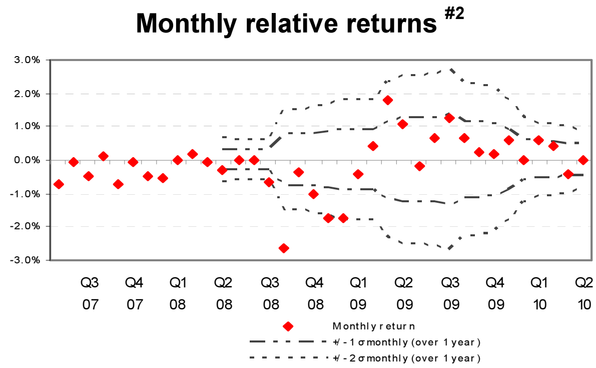
Source: Data provided by WM Performance Services, and BlackRock

Comments:

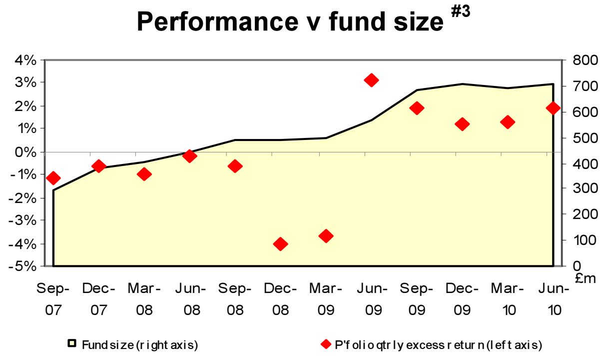
- Over the last quarter the Fund underperformed the benchmark by 0.3%, producing an absolute return of -2.5%.
- Over the last year the Fund produced a return of 8.1%, underperforming the benchmark by 0.1%. Over the period since inception the Fund produced as absolute return of 1.4%p.a., which was broadly in line with the benchmark return.
- Despite a high cash element, the Fund has produced a relatively low absolute return. Over the last year it has produced a return very close to the benchmark.
- Being passively managed the relative performance has been marginal over the last 12 quarters. This is positive as it indicates minimal relative risk in the portfolio.
- The magnitude of the relative volatility in the portfolio is very small.
- There was no significant change to the asset allocation over the year.

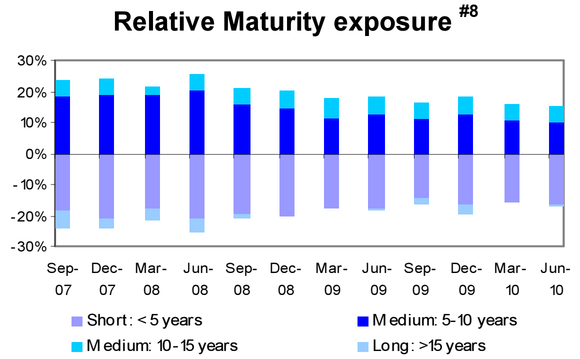
Royal London Asset Management – Fixed Interest

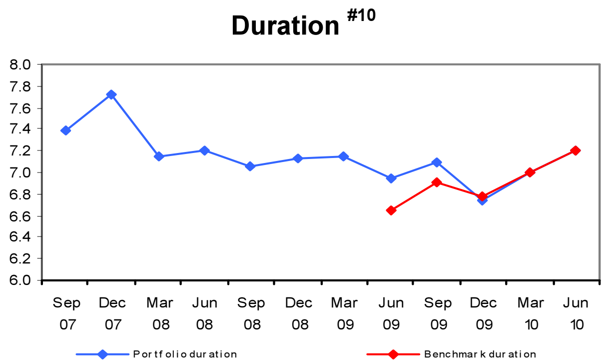


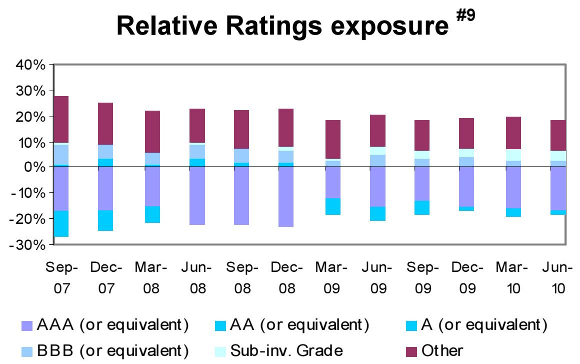


note: Q3 2007 is only a partial period of investment









Source: Data provided by WM Performance Services, and RLAM

Comments:

- Over the last quarter the Fund performed in line with the benchmark, producing an absolute return of 1.9%.
- Over the last year the Fund outperformed the benchmark by 4.6%, producing an absolute return of 20.5%. Over the period since inception the Fund underperformed the benchmark by 1.7% p.a., producing an absolute return of 3.9% p.a.
- The Fund performed in line with the benchmark over the last quarter, this is despite the portfolio being underweight to AAA, in favour of BBB, sub-investment and unrated bonds.
- The Fund continues to be considerably overweight in medium term maturity bonds, and underweight short maturity bonds.

Schroder – UK Property

- The mandate awarded to Schroders by the Fund commenced in February 2009.
- The Fund appointed Schroder to manage UK property on a segregated, multi-manager basis. The investments held within the underlying funds are primarily direct, although some managers might use listed securities for diversification.
- Due to the recency of the first investments into the portfolio, a full quantitative assessment of Schroder is not yet possible. However, we provide here a qualitative update and assessment of the manager.

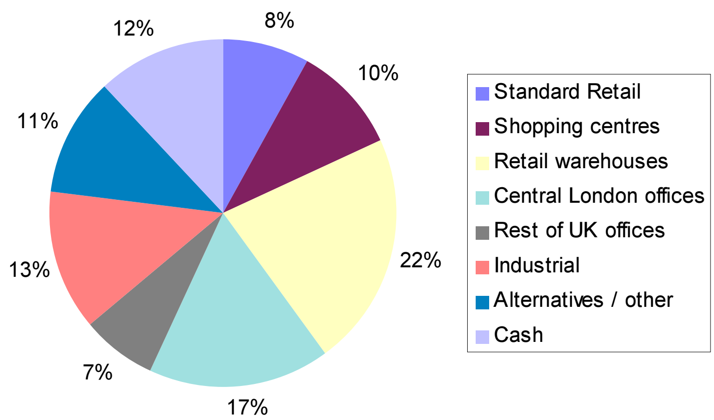
Portfolio update

As at 10 August 2010, approximately 84% of the Fund's £90million committed cash had been drawn by Schroder.

To date, the drawn down monies have been invested across 13 different underlying funds. Of these funds, 4 are "core" investments (comprising 58% of the total portfolio) and 9 are "value add" investments (the remaining 42% of the portfolio).

The investments in the funds noted above have resulted in a UK property portfolio that, as at 30 June 2010, was split between sectors as shown in the following chart.

Portfolio split by sector



In terms of relative positioning, the allocations above are, compared with the benchmark (the UK IPD Pooled Property Index), underweight standard retail, non-London offices and industrial properties and overweight in the other sectors. The most significant overweights are to central London offices and cash.

Although the portfolio is not yet fully invested the allocation is consistent with Schroder's outlook. For example, they believe that non-London offices may be vulnerable to government spending cuts, whereas central London offices, and the South East more generally, will be potentially more resilient. Cash is above benchmark levels due to one particular holding, the Hansteen UK Industrial Property Unit Trust, which has a high proportion of cash. However, with capital values now stabilising somewhat, Schroder are less concerned about the opportunity cost of holding cash than would have been the case twelve months ago.

Over the latest quarter, Schroder made two new investments, totalling approximately £1.6 million. The monies were invested into:

- The Columbus UK Real Estate Fund, which recently acquired its first asset in the form of a shopping centre in Motherwell, which Schroder note has a secure income profile with scope to increase the rental income. The price paid for the property was at a 45% discount to that paid in 2007 by the previous owner.
- The Henderson UK Retail Warehouse Fund, where Schroder believe that the underlying properties held are attractive, and debt is secured on favourable terms until the expiry of the fund

Performance over Q2 2010

Schroder produced a return of 3.6% over the three months to 30 June 2010, versus the benchmark return of 3.1%. The key drivers of the relative return over the period were:

- Allocations to the West End of London Property Unit Trust, the Standard Life Investments Pooled Pensions Property Fund and the Threadneedle Investments Strategic Property Fund IV.
- Investments with higher than average gearing levels, in particular value add and opportunity funds, have boosted returns over the quarter, and over the last twelve months as a whole.
- On the negative side, Schroder's circa 5% allocation to the Hansteen UK Industrial Property Unit Trust has disappointed, driven by this Unit Trust's high levels of uninvested cash, which has diluted returns. Schroder remain confident that this particular fund's strategy of buying high yielding multi-let industrial estates from distressed sellers will be successful over the longer term.

Conclusion

Schroder's intention when they were appointed was to fully establish the Fund's portfolio over a period of around 18 months, and this appears to be on track. The portfolio is diverse, as one might expect for a multi-manager vehicle, although even at this early stage evidence of Schroder's outlook can be seen in the portfolio positioning. Schroder do note that the portfolio sector structure and property fund allocations will be reviewed again once the portfolio is fully invested.

We have no concerns with Schroder. We also note that they are due to attend the September Investment Panel meeting, where their outlook and strategy will be discussed further.

Partners – Overseas Property

- The mandate awarded to Partners by the Fund commenced in August 2009, although draw downs are being made gradually over time, and the full extent of the Fund's commitment has not yet been invested.
- Partners invest in direct, primary and secondary private real estate investments on a global basis.

Portfolio update

To date, Partners have drawn down approximately £32.3 million of the Fund's intended commitment of approximately £90 million. The draw downs commenced in September 2009.

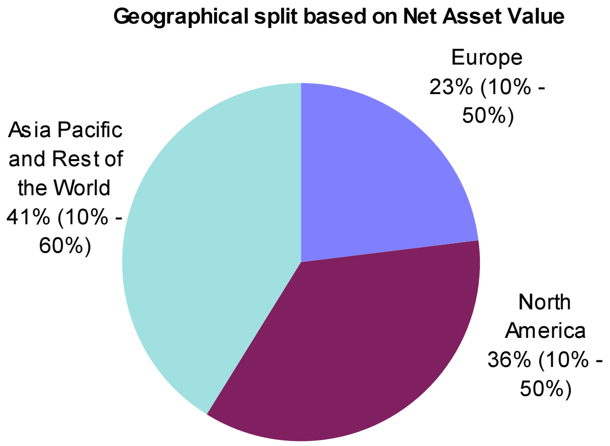
Partners have communicated that the extent of the draw downs to date are broadly as they expected, and they note that their strategy is to build a diversified portfolio in a disciplined manner, spread across different "vintage" years.

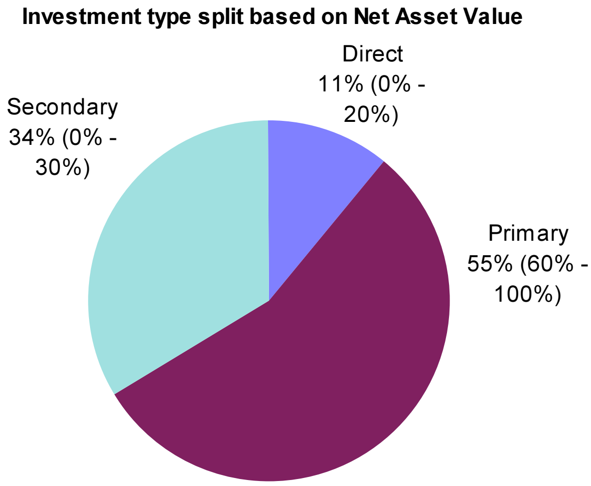
The funds invested to date have been split by Partners between funds as follows:

Partners Fund	Net Drawn Down (£ m)	Net Asset Value as at 30 June 2010 (£m)
Asia Pacific and Emerging Market Real Estate 2009	5.81	6.02
Distressed US Real Estate 2009	7.65	8.28
Global Real Estate 2008	15.65	14.54
Real Estate Secondary 2009	3.22	3.17
Total	**32.33**	**32.01**

Source: Partners

The investments in the funds noted above have resulted in a portfolio that was, as at 30 June 2010, split regionally as shown in the chart on the left below, and across different investment types as shown on the right. We show in brackets for each region the current guideline allocations to each region that are in place for the Fund's portfolio.





Source: Partners

The geographical allocation shown is consistent with Partners' current investment outlook, which favours Asia Pacific and Emerging Markets on the grounds that such economies will drive future global growth. In contrast, Partners believe that Europe’s sovereign debt crisis creates risks on the downside for Europe, hence the relative underweight to this region. Partners are have a broadly neutral view with respect to North America, and the current overweight to this region is expected to reduce as further draw downs are made.

In terms of the portfolio allocation by investment type, currently Partners are underweight primary investments and this allocation is below the lower bound of the investment restrictions in place for the longer term portfolio, with a commensurate overweight to secondary investments.

Short term deviation from the allocation restrictions in place can be expected at such an early stage of investment and we do not believe the current positioning to be of concern. Additionally, the overweight to secondary investments reflects Partners' strong view that this market offers attractive value.

Encouragingly, the Fund's portfolio has already experienced its first distributions (to date, distributions of approximately £0.61 million have been paid). This would ordinarily be unexpected from a private investment portfolio, however, Partners' use of secondary vehicles, many of which they have been able to purchase at a discount from distressed sellers, are at the stage where distributions are being made.

Performance over Q2 2010

Partners produced a return of 2.0% over the three months to 30 June 2010. Information for the portfolio's stated benchmark (the IPD Global Pooled Property Index) is not yet available. We do note that the Partners portfolio proved a good diversifier from global equities over this short period. Performance attribution for

Partners is unavailable at this point, as benchmark data is not yet published and the Fund's investments are at such an early stage.

Conclusion

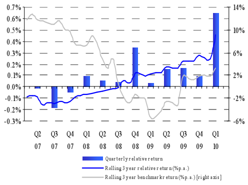
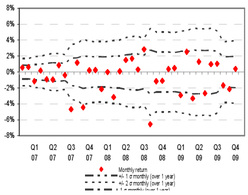
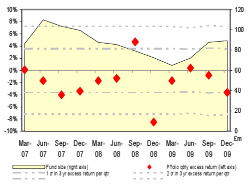
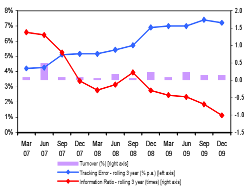
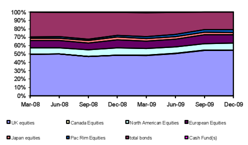
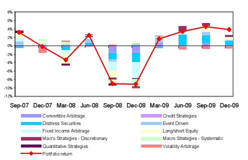
The early stages of investment in a private real estate portfolio are about establishing a diversified portfolio whilst aiming to mitigate the "J curve effect" (the tendency of private investments to deliver negative returns in early years, driven by initial costs, and positive returns in later years as the portfolio matures).

Although it remains very early days for Partners, they have stuck to their stated approach of building a diverse portfolio by region, type of investment (primary, secondary and direct), and by vintage year. The manager has employed a strategy whereby value opportunities are attained via the purchase of perceived high quality funds at discounts from distressed sellers, and growth is sought by overweighting Emerging Markets. This appears to be a sensible approach to mitigating the impact of the J-curve effect

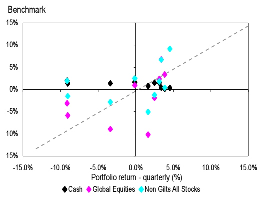
We have no concerns with Partners. We also note that they are due to attend the September Investment Panel meeting, where their outlook and strategy will be discussed further.

Appendix A - Glossary of Charts

The following provides a description of the charts used in Section 5 and a brief description of their interpretation.

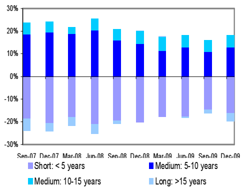
Reference	***Description***
#1 	This chart shows the quarterly relative return (blue bars) and rolling 3 year relative return (blue line) for the manager over 3 years/since inception. This shows the ability of the manager to achieve and outperform the benchmark over the medium term. The rolling 3 year benchmark absolute return (grey line) is overlayed to provide a context for relative performance, e.g. consistent underperformance in a falling market.
#2 	This chart shows the relative monthly returns for 3 years/since inception. It shows the level of fluctuation about the zero axis, i.e. the level of volatility of monthly returns and any tendency for positive or negative returns. The dotted lines show the standard deviation of returns over 1 year periods - this is a standard measure of risk which shows the magnitude of fluctuations of monthly returns. Under common **assumptions**, being within the inside dotted lines (i.e. 1 standard deviation) is roughly likely to occur 2/3rds of the time, while being within the outside lines is roughly likely to occur 1 in 20 times (i.e. 2 standard deviation - which is considered unlikely).
#3 	This chart shows the relative performance on a quarterly basis. The dotted lines show the standard deviation of returns for a quarter - based on the latest quarter 3 year standard deviation. (See #2 above for further detail on interpretation). The total size of the underlying fund is overlayed in yellow (portfolio value in blue) to identify any trend in diminished performance with increasing fund (portfolio) size, as sometimes observed.
#4 	This chart shows the 3 year annualised tracking error (this is the standard deviation of returns which shows the magnitude of the fund returns compared to the benchmark) and the 3 year information ratio (this is the excess return divided by the tracking error). If tracking error increases, the risk taken away from the benchmark increases, and we would expect an increase in the excess return over time (albeit more variable). The turnover is provided to show if any increase in risk is reflected in an increase in the level of active management, i.e. purchases/sales in the portfolio.
#5 	This chart shows the absolute asset allocation or hedge fund strategy allocation over time. This helps to identify any significant change or trends over time in allocation to particular asset allocations/hedge fund strategies.
#6 	These charts show the breakdown of the return provided by each of the different hedge fund strategies or asset classes over time - this provides a profile of where the returns come from, and should be compared with the volatility chart above to see if risk taken is being rewarded accordingly. The total portfolio return is also shown.

#7



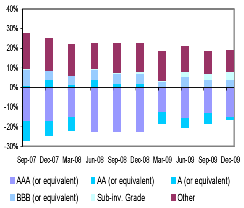
This chart plots the quarterly returns of the fund against quarterly returns of various indices. Any plots on the diagonal line represent the fund and the index achieving the same quarterly return - any below the line represents underperformance relative to the index, above the line represents outperformance. This is to highlight any apparent correlation between the fund returns and any particular index. If a fund is used as a diversifier from, say equities, we would expect to see a lack of returns plotted close to the diagonal line.

#8



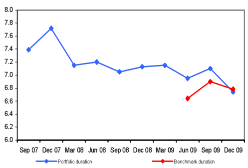
This chart shows the holding in short, medium and long maturity bonds relative to the benchmark. Over/underweight positions expose the fund to changes in the yield curve at different terms.

#9



This chart shows the holding in bonds with different credit ratings. AAA is the highest grading (usually for government or supranational organisation bonds) while below BBB is sub-investment grade and has a considerably higher risk of default. The lower the grade the higher the risk and therefore the higher the return expected on the bond.

#10



This chart shows the duration of the fund against the benchmark duration. It shows whether the fixed interest fund manager is taking duration bets against the benchmark.

Appendix B - Summary of Mandates

Manager	Mandate	Benchmark	Outperformance target (p.a.)
Jupiter	UK Equities (Socially Responsible Investing)	FTSE All Share	+2%
TT International	UK Equities (Unconstrained)	FTSE All Share	+3-4%
Invesco	Global ex-UK Equities Enhanced (En. Indexation)	MSCI World ex UK NDR	+0.5%
SSgA	Europe ex-UK Equities (Enhanced Indexation)	FTSE AW Europe ex UK	+0.5%
SSgA	Pacific inc. Japan Equities (Enhanced Indexation)	FTSE AW Dev Asia Pacific	+0.5%
Genesis	Emerging Market Equities	MSCI EM IMI TR	-
Lyster Watson	Fund of Hedge Funds	3M LIBOR + 4%	+0-2%
MAN	Fund of Hedge Funds	3M LIBOR + 5.75%	+0-0.25%
Signet	Fund of Hedge Funds	3M LIBOR + 3%	+1-3%
Stenham	Fund of Hedge Funds	3M LIBOR + 3%	+1-3%
Gottex	Fund of Hedge Funds	3M LIBOR + 3%	+1-3%
BlackRock	Passive Multi-asset	In line with customised benchmarks using monthly mean fund weights	0%
BlackRock	Overseas Property	Customised benchmarks using monthly mean fund weights	0%
RLAM	UK Corporate Bond Fund	iBoxx £ non-Gilts all maturities	+0.8%
Schroder	UK Property	IPD UK pooled	+1.0%
Partners	Global Property	IPD Global pooled	+2.0%
Cash	Internally Managed	7 day LIBID	

JLT Benefit Solutions

St James's House, 7 Charlotte Street
Manchester, M1 4DZ
Fax +44 (0) 161 253 1169

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Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**	
MEETING DATE:	**16 SEPTEMBER 2010**	**AGENDA ITEM NUMBER**
TITLE:	**PANEL WORKPLAN**	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of attachments to this report: Nil		

1 THE ISSUE

1.1 This report sets out the workplan for the Panel to end 2010. The workplan is provisional as will respond to issues as they arise and instructions from the Committee.

1.2 The workplan will be updated for each Panel meeting.

2 RECOMMENDATION

2.1 **That the Panel agrees the workplan to be recommended to the Committee.**

3 FINANCIAL IMPLICATIONS

3.1 There are no financial implications arising from this report.

4 PROVISIONAL WORKPLAN

4.1 The provisional workplan is as follows:

Panel meeting	Proposed reports	Outcome
11 November 2010	• Meet Hedge fund managers • Update on global equity tender	• Input to committee workshop (1Q11)
1Q11	• Review of Hedge Fund managers – performance and meet the managers • Review managers performance to Sept 10	• Input to committee workshop in 1Q11 • Agree any recommendations to Committee

4.2 The Panel’s workplan will be included in the regular committee report setting out the committee’s and pensions section workplans. This will enable the Committee to approve or alter the planned work of the Panel.

5 RISK MANAGEMENT

5.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in place that is regularly monitored. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

6 EQUALITIES

6.1 An equalities impact assessment is not necessary.

7 CONSULTATION

7.1 N/a

8 ISSUES TO CONSIDER IN REACHING THE DECISION

8.1 This report is for discussion.

9 ADVICE SOUGHT

9.1 The Council's Monitoring Officer (Council Solicitor) and Section 151 Officer (Director of Resources and Support Services) have had the opportunity to input to this report and have cleared it for publication.

Contact person	Liz Feinstein, Investments Manager 01225 395306
Background papers	
Please contact the report author if you need to access this report in an alternative format	