

<b>Bath &amp; North East Somerset Council</b>		
<b>MEETING:</b>	<b>AVON PENSION FUND INVESTMENT PANEL</b>	
<b>MEETING DATE:</b>	<b>11 NOVEMBER 2010</b>	<b>AGENDA ITEM NUMBER</b>
<b>TITLE:</b>	<b>REVIEW OF FUND OF HEDGE FUND MANAGERS</b>	
<b>WARD:</b>	ALL	
<b>AN OPEN PUBLIC ITEM</b>		
<p>List of Attachments:</p> <p>Exempt Appendix 1 – JLT’s Report on Hedge Fund Managers November 2010</p> <p>Appendix 2 – Background information on MAN</p> <p>Appendix 3 – Background information on Gottex</p>		

## **1 THE ISSUE**

- 1.1 Following the review of the Strategic Investment Strategy in June 2009, it was agreed that a formal review of the Fund’s investments in hedge funds be undertaken in 2010/11 once the mandates had been in place for three years. A Committee workshop will be arranged for 1Q11 where the strategic allocation to hedge funds and the managers will be reviewed.
- 1.2 Prior to the workshop, the Investment Panel have been asked to review performance of the individual Fund of Hedge Fund (FoHF) managers. The Panel will meet each of the managers and JLT have prepared a report (see Exempt Appendix 1) that reviews performance, operational and management issues as well as the managers’ exposure to the underlying investment strategies. JLT’s main findings are set out in 6.4. At this stage of the review, the focus is on the individual managers and not on the strategic decision to invest in hedge funds.
- 1.3 Appendices 2 & 3 provide background information on the managers presenting at this meeting, MAN and Gottex.

## **2 RECOMMENDATION**

**That the Investment Panel:**

- 2.1 Identifies issues with the individual hedge fund managers to be incorporated into the review of the Fund’s hedge fund investments**

### **3 FINANCIAL IMPLICATIONS**

3.1 The budget provides for investment advice to review the hedge fund portfolio.

### **4 FRAMEWORK FOR REVIEW OF HEDGE FUNDS**

4.1 The Investment Panel recommended the following framework for the review of the hedge fund portfolio:

- (1) Review of the managers by the Investment Panel
- (2) Strategic Review of allocation to hedge funds by the Investment Consultant
- (3) Review of regulation changes and potential impact on investment opportunities
- (4) Committee workshop in Q1 2011 to review hedge funds (covering 1-3 above).

### **5 CONTEXT - RECAP ON RATIONALE & STRUCTURE OF HEDGE FUND PORTFOLIO**

5.1 In order to put the individual managers into context, the following briefly summarises the rationale for the hedge fund portfolio and the portfolio structure.

5.2 The Fund allocated 10% to fund of hedge funds and was seeking to generate consistent annual returns (net of fees) of LIBOR plus 4-6% with a volatility of less than 10%. The portfolio was to have a focus on capital preservation. The Fund was therefore looking for a relatively low volatility, low-medium return portfolio and given the nature of FoHF portfolios it was decided that more than one manager would need to be appointed in order to achieve the optimum volatility/return profile.

5.3 As a result the five FoHF managers were appointed, the combination of them providing the required volatility /return profile and a diverse exposure to underlying strategies. In particular, three of the managers, Signet, Gottex and Stenham were selected given their relatively low volatility profile, with commensurate lower return potential. MAN and Lyster Watson were selected as they had higher volatility and return objectives. Thus they would help the Fund achieve its return objective whereas as the lower volatility managers would provide capital protection and dampen overall volatility.

5.4 In addition, the five managers have different approaches to investing which means the overall portfolio will have a well diversified exposure to the main underlying investment strategies. *Please see pages 37-38 of JLT report (Exempt Appendix 1) for definition of investment strategies.*

5.5 MAN and Lyster Watson are multi-strategy managers meaning they are opportunistic and allocate capital across the full range of hedge fund strategies. The diversification within each portfolio will reduce volatility and help smooth returns over time.

5.6 Gottex, Signet and Stenham have more focussed approaches to investing. Stenham are a multi strategy manager but only invest in liquid investment strategies where they are not reliant on leverage to enhance returns. Therefore

they would expect to allocate most capital to long/short equity, macro, commodities and event driven strategies.

5.7 Gottex are a market neutral manager meaning they will not take any significant positions that rely on return being generated from market movements (i.e. do not bet on equity, bond, currency or commodity market trends). As a result they allocate capital to “relative value” and arbitrage strategies amongst others.

5.8 Signet focuses purely on fixed income and credit strategies; they will allocate to both market neutral and directional strategies within the fixed income and credit markets.

## **6 REVIEW OF INDIVIDUAL FUND OF HEDGE FUND MANAGERS**

6.1 This review is in two parts: (i) a report by JLT and (ii) Panel meetings with each manager. These meetings and JLT’s report will form the basis for the assessment of the individual managers by the Investment Panel.

### **Report by JLT**

6.2 JLT’s report in Exempt Appendix 1 provides analysis on each individual hedge fund manager. These managers have been managing assets on behalf of the Fund for just over three years, which has been a tumultuous period in financial markets and the global economy. The JLT report reviews what each manager might reasonably be expected of them against this backdrop. The report summarises their initial findings on each manager and highlights issues where the Panel may wish to obtain further assurance.

6.3 The report is set out as follows:

- (1) Section 1 – Investment Performance over last 3 years
- (2) Section 2 – Allocation to underlying investment strategies and how these have changed over time
- (3) Section 3 – Operational Structure and performance discusses how the managers have strengthened their operational and due diligence processes

6.4 **JLT’s initial findings** are summarised as follows (please refer to Executive Summary in Exempt Appendix 1, page 2 for full summary):

- (1) Performance has been disappointing as none of the managers have achieved their performance target since inception. However, this is mainly due to poor performance against target in 2008; performance has improved in 2009 and 2010. The investment return of the hedge fund portfolio has been significantly less volatile than the return from global equities.
- (2) As expected the managers have actively altered allocations between investment strategies in response to opportunities within their investment universe and have reduced exposure to strategies that relied on leverage to enhance return. However, JLT’s initial findings are that there is a risk that the highly diversified structure of some managers’ portfolios could dilute the overall contribution to return from the active management by the manager and therefore the Fund should review this issue.
- (3) All the managers faced significant operational challenges in 2008/09 with regard to managing redemptions and liquidity of underlying investments. As a result all managers have reviewed their internal processes and managers

have addressed areas identified as weak. JLT recommend that given the more challenging environment in which FoHF managers now operate, the Panel should conclude whether each of the managers has adequate resources and processes in place to meet these challenges.

## **Manager Meetings**

6.5 At the meetings the Panel are asked to review performance of the FoHF managers, focusing on:

- (1) Their exposure to underlying investment strategies
- (2) The three year investment performance
- (3) Their operational / management performance, including changes introduced since 2008 financial crisis

6.6 MAN and Gottex will present to the Panel at the meeting on 11 November 2010. The other three FoHF managers will present at the Investment Panel meeting in January 2011.

6.7 Appendices 2 and 3 provide background information on MAN and Gottex, which should be read in conjunction with the report by JLT. Potential questions which cover areas the Panel may wish to focus on will be circulated at the presentations.

## **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.

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<b>Background papers</b>	
<b>Please contact the report author if you need to access this report in an alternative format</b>	