Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND COMMITTEE**	
MEETING DATE:	**18 March 2011**	**AGENDA ITEM NUMBER**
TITLE:	**HEDGE FUND REVIEW**	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of attachments to this report: Exempt Appendix 1 – Summary of Investment Panel meetings with Hedge Fund Managers Exempt Appendix 2 – Strategic Report on hedge fund portfolio		

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 investment in hedge funds be undertaken in 2010/11 once the mandates had been in place for three years.

1.2 A review of the operational and investment performance of the current fund of hedge fund managers was undertaken by the Fund's investment consultant JLT, and the Investment Panel. This was followed by a Committee workshop on 2 March 2011 where the strategic allocation to hedge funds and each manager was reviewed.

1.3 The outcome of the review and the review process is summarised below and the Committee are requested to agree the recommendations concluded by the review.

2 RECOMMENDATION

2.1 **That the Committee agrees the following recommendations following the review of the Fund's hedge fund investments:**

- **(i) The allocations between Fund of Hedge Fund (FoHF) managers should be amended as set out in paragraph 5.5 (3)**
- **(ii) The hedge fund investments should be reviewed in 3 years time**

3 FINANCIAL IMPLICATIONS

3.1 The budget provides for the investment advice required for this review.

4 REVIEW OF HEDGE FUND INVESTMENTS - PROCESS

4.1 This review of the Fund's hedge fund investments began in Q4 2010 and has consisted of:

(1) **Review of the managers by the Investment Panel**

Review performance of the FoHF managers including 3 year investment performance, operational performance, exposure to underlying investment strategies, changes introduced to investment and operational process since 2008/09 by the Investment Panel (supported by investment consultant).

The Panel met with each of the managers between November 2010 and January 2011 and a summary of their conclusions from these meetings can be found in Exempt Appendix 1. In addition, a background report on each of the managers was prepared by JLT prior to the meetings.

(2) **Review of regulation changes and potential impact on investment opportunities**

The Fund commissioned expert legal advice from Osborne Clarke to assess the known regulation framework and potential regulatory changes and to evaluate the opportunities and threats posed to the Fund's hedge fund portfolio and strategy. This was reviewed by Officers and JLT and incorporated by JLT into the strategic review (see (3) below).

(3) **Strategic Review by the Investment Consultant**

JLT have prepared a Strategic report on the Hedge Fund Portfolio (see Exempt Appendix 2), including applying the conclusions from the report on regulatory changes to the hedge fund portfolio. The Strategic Report considered the following:

(i) Is a strategic allocation to hedge funds still appropriate?

(ii) Does the 10% strategic allocation remain appropriate?

(iii) Will the allocation between strategies meet the objectives?

(iv)Taking into account the review of operational and investment performance, is the allocation between managers still appropriate?

(4) **Committee workshop on 2 March 2011 to review the hedge fund portfolio**

The workshop brought together 1-3 above, with the Committee debating the Strategic Report and the Panel's conclusions about the managers' performance and drawing conclusions to be taken to the March Committee meeting.

4.2 The conclusions from the committee workshop are set out below in section 5.

5 REVIEW OF HEDGE FUND INVESTMENTS – CONCLUSIONS

5.1 The Conclusions from the workshop were as follows:

5.2 **An allocation to Hedge Funds is still appropriate**

(1) The hedge fund investments has achieved the reduced volatility, diversification and capital preservation objectives, but has not achieved the performance targets over the period since inception. The Workshop recognised the exceptional investment environment during the period under review and the impact this had upon performance across all asset returns. Furthermore, the Committee concluded that the short term performance did not indicate that the long term performance target could not be achieved going forward.

(2) The impact of the new regulatory framework should strengthen investor protection and improve transparency of hedge funds. It was also acknowledged that the Fund's current managers already comply with the new framework to a significant degree.

(3) The allocation to hedge funds has brought diversification benefits to the overall Fund in terms of lower volatility of return and the Workshop concluded that an allocation to hedge funds is still appropriate.

5.3 **A 10 % allocation to Hedge Funds is still appropriate**

(1) The Workshop concluded that there were no reasons to alter the current 10% allocation. There was no justification for an increase in the allocation at this time and it was recognised that a meaningful reduction in the allocation would undermine the original objectives. The Committee concluded that it was too short a timeframe since inception upon which to make a decision to change the strategic allocation. It was recommended that this be reviewed again in 3 years time.

5.4 **The allocation between strategies remains appropriate**

(1) The FoHF managers have actively allocated between strategies and this added value to the Fund.

(2) The Workshop considered the risk from the leverage implicit within the various strategies employed by the underlying managers and identified that another dislocation in financial markets could have a greater negative impact on those strategies more reliant upon leverage. This issue was carried forward for consideration when discussing the allocation to the individual managers.

(3) The Workshop concluded that the allocation between strategies was appropriate to meet the objectives. It was noted that any change in allocation between managers would affect the allocation between strategies and this was also carried forward for consideration when discussing the allocation to the individual managers.

5.5 **The allocation between managers should be amended**

(1) Broad conclusions from the Investment Panel's review of the 5 FoHF managers identified a number of potential changes to the allocations to the

managers. Based on information that became available subsequent to the Panel's review, JLT added a recommendation that the allocation to Lyster Watson be redeemed.

(2) The Workshop discussed each manager and drew the following conclusions:

(i) Man's allocation should be reduced as there was no longer justification for maintaining the higher allocation within the portfolio given the organisation was undergoing significant change and the underlying portfolio is highly diversified which could dilute the potential returns.

(ii) Lyster Watson's allocation should be redeemed. This was based on the current small allocation which the Committee were not minded to increase, the need for the Fund to internally hedge the portfolio and as a US based manager with limited EU clients, there is a greater risk in complying with the proposed EU based regulations.

(iii) The allocation to Signet and Stenham should be increased, reflecting their ability to deliver return and volatility targets and their more focused investment strategies.

(iv) Gottex's allocation should remain unchanged. The Committee has concerns over the level of leverage employed by market neutral strategies. It was noted that Gottex has reduced the amount of leverage across the fund, but was agreed that the amount of leverage and the associated risks should be monitored by Officers.

(3) The Workshop concluded that the allocation between managers should be amended as follows:

(i) Reduce Man's share of the portfolio from 45% to 30%

(ii) Reduce Lyster Watson's share of the portfolio from 5% to zero.

(iii) Increase Signet's share of the portfolio from 20% to 30%,

(iv) Increase Stenham's share of the portfolio from 5% to 15%.

Note that the allocation Gottex remains unchanged.

5.6 It was agreed that these changes be implemented as soon as practical.

5.7 In coming to the conclusions on each manager's allocation, the effect of the proposed changes on the expected performance and volatility in aggregate across all managers was discussed and it was noted that although expectations of return and volatility would be dampened slightly, the revisions were still in line with the original targets for performance and volatility. The impact upon the underlying diversification by strategy was also considered and it was concluded that the portfolio would remain well-diversified by both strategy and FoHF manager.

6 RISK MANAGEMENT

6.1 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. In addition it monitors the benefits administration, the risk register and compliance with relevant investment, finance and administration regulations. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

7 EQUALITIES

7.1 An equalities impact assessment is not necessary.

8 CONSULTATION

8.1 N/a

9 ISSUES TO CONSIDER IN REACHING THE DECISION

9.1 The issues being considered are contained in the report.

10 ADVICE SOUGHT

10.1 The Council's Monitoring Officer 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	Current Developments in hedge fund regulation – Osborne Clarke, January 2011 Background report on hedge fund managers – JLT, November 2010