	Pension Fund Sub Committee 23rd February 2010 **Report from the Director of Finance and Corporate Resources**
For Action	Wards Affected: ALL

Report Title: Henderson Global Investors - Benchmark

This report is confidential

1 Summary

1.1 This report examines the UK government gilt benchmark used by Henderson Global Investors (HGI).

2 Recommendations

2.1 Members are asked to agree to amend the benchmark as suggested by HGI.

3.0 Detail

3.1 At the previous meeting of the Pension Fund Sub Committee on 24th November 2009, members decided to defer a decision on advice from HGI to amend the government gilt benchmark within the core portfolio from the Over 15 year gilt to the average length gilt (15.2 years) in the FTSE All Stocks index.

3.2 The use of the Over 15 year gilt benchmark has been beneficial to the Fund as long dated interest rates have fallen. This has been part of a long-term gilt bull market since 1981, during which rates have fallen from around 16% (to curb inflation) to 4%.

3.3 HGI tend to be very benchmark focused, measuring the risk of not meeting the benchmark. However, the house suggests that there are fundamental reasons why the gilt market may be changing and that the long term bull market may be ending. First, HGI expect longer term rates to rise as the UK government issues more gilts, quantitative easing ends, inflation fears rise and to encourage overseas buyers to purchase UK debt. HGI expect the longest dated (over ten years, up to fifty years) to be worst affected as rates rise, because prices may fall fairly sharply. Appendix 1, written by Henderson, outlines the potential cost of a 1% / 2% rise in gilt yields, and shows that losses may be smaller if the manager adjusts the portfolio in line with the All Stocks benchmark

3.4 Most economists would support HGI's view that gilt rates are likely to rise, and most would also agree that the longer dated stocks are most at risk. However, there is an alternative view that argues that UK is placed similar to Japan in the 1990's, when deflation took hold and long rates sunk very low. Such economists as Capital Dynamics argue that the current gap between productive capacity and consumption, as illustrated by low GDP growth, means that there will be deflationary pressures within the UK economy. These pressures will be strengthened as governments take steps to reduce the fiscal deficit, further reducing demand. Whichever view is taken, it is suggested that it would be sensible to reduce risk within the core gilt portfolio, but to maintain exposure to gilts in case rates fall (prices rise).

4.0 Financial Implications

4.1 These are outlined within the report.

5.0 Staffing Implications

5.1 There are no staffing implications.

6.0 Legal Implications

6.1 There are no legal implications.

7.0 Diversity Implications

7.1 The proposals in this report have been subject to screening and officers believe that there are no diversity implications.

8.0 Background Information

Monitoring Report to Pension Fund Sub Committee 24th November 2009.

Contact Officer

Martin Spriggs – Head of Exchequer and Investment

Appendix 1 – Note from Henderson

Gilt yields and your fixed income portfolio's capital value with existing and revised benchmarks

The following tables set out the potential impact on the capital value of your fixed income portfolio managed by Henderson in the event that gilt yields rise materially. The analysis takes two scenarios:

1) a rise in all gilt yields of 1%

2) a rise in all gilt yields of 2%

We model the potential impact of these market moves under two conditions:

a) Your existing benchmark remains in place

b) Your benchmark is amended to have a lower sensitivity to rising gilt yields (a lower duration) through changing the benchmark for the UK gilt element from the FTSE >15 year Gilt index to the FTSE All Stocks.

Both the percentage and actual potential impacts on the capital value are set out in the table below.

	Change in Gilt yields	
	+1%	**+2%**
Brent Existing Benchmark	-5.5%	-11.1%
Brent Revised Benchmark	-3.8%	-7.6%
Potential impact of benchmark change	1.7%	3.4%
	+1%	**+2%**
Brent Existing Benchmark	-£4.6m	-£9.2m
Brent Revised Benchmark	-£3.2m	-£6.4m
Potential impact of benchmark change	+£1.4m	+£2.8m

This analysis makes a number of assumptions:

The rise in yields occurs equally in gilt, index-linked and sterling corporate bond markets and across all bond maturities (a parallel move in the yield curve).
There is no impact on the capital value of the Enhanced sub-portfolio as interest rate risk is broadly zero in the Enhanced portion.
Your core portfolio maintains its interest rate risk (duration) at benchmark. (If we had a high conviction that gilt yields were likely to rise we would of course position the portfolio within existing permitted ranges in order to mitigate the impact but this would have a much less significant impact than a strategic benchmark change that alters the reference point around which we manage the portfolio.)
We assume the rise in gilt yields is immediate. In reality there will be income accruing to the portfolio over time and this is not taken in to account.
In practice the impact of the 2% rise in gilt yields will be a little less than double the 1% rise.