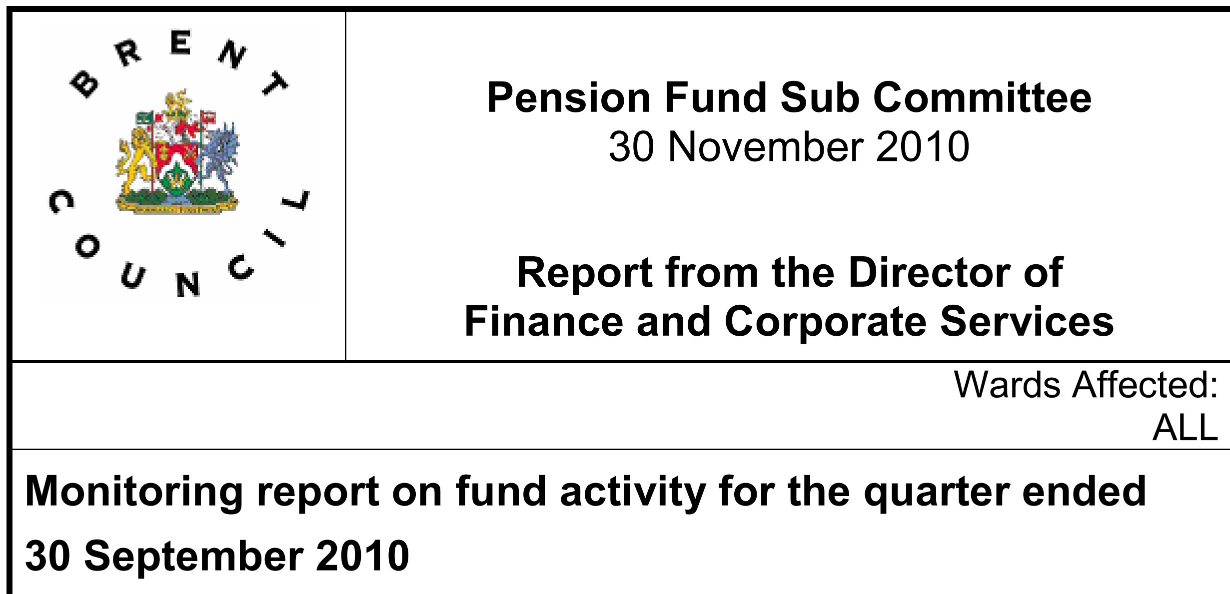


Pension Fund Sub Committee
30 November 2010

Report from the Director of Finance and Corporate Services

Wards Affected:
ALL

Monitoring report on fund activity for the quarter ended 30 September 2010

1. SUMMARY

This report provides a summary of fund activity during the quarter ended 30th September 2010. It examines the actions taken, the economic and market background, and investment performance, as well as commenting on events in the quarter. The main points arising are:

a) Equity markets rose sharply during the quarter, recovering the losses sustained in the previous quarter. Other markets also rose, but less rapidly.

b) The Fund has risen in value from £424.6m to £454.1m, and has outperformed its benchmark over the quarter (0.8%) as a result of stock selection (outperformance in bonds, GTAA and private equity). The Fund underperformed the average local authority fund (-1.4%), mainly as a result of asset allocation (higher exposure to alternatives / lower exposure to equities). Over one year, the Fund has outperformed its benchmark (0.1%) as a result of poor returns from asset allocation (-0.5 – higher exposure to alternatives and bonds / lower exposure to equities, property and GTAA) offset by good stock selection (+0.6% - UK equities, bonds, private equity and GTAA, offset by poor performance in overseas equities and hedge funds). Over one year, the Fund has also underperformed the average fund (-3.4%) as a result of lower exposure to equities / higher exposure to alternative assets and poor performance in global equities.

2. RECOMMENDATIONS

Members are asked to note this report.

3 DETAIL

ECONOMIC AND MARKET BACKGROUND - QUARTER ENDED 30TH SEPTEMBER 2010

3.1 Equity markets rose during the quarter on the bases of world economic growth and the likelihood of renewed Quantitative Easing in USA and elsewhere. The

UK rose by 13%, USA 11%, Germany 10%, and HongKong 11%. The Japanese market was stable. The UK economic background was:

- UK base rates remained at 0.5%. Medium and long-term interest rates fell during the quarter. Concerns about the European banking system and various eurozone countries (Greece, Portugal and Spain) have affected these markets, but UK has benefited from a safe haven status.The Quantitative Easing programme in UK has been suspended, but may restart.
- Headline inflation (RPI) rose by 4.5% in the year to October (4.7% August), and the Index of Consumer Prices (CPI) rose by 3.2% (3.1% August). It is expected that inflation may fall over a two year period as spare capacity and low pay increases bear down on prices, but it is expected that CPI will be above the Bank of England 2% target during 2011.
- Average earnings growth (including bonuses) was 2.2% p.a. in September (1.8% July), below the Bank of England's 'danger level' (4.5%). Unemployment has fallen to 1.46m, but may rise as public expenditure is reduced and taxes raised following the recent budget.
- The UK economy grew by 0.8% in Q3 2010 (2.8% over a year). GDP is expected to grow by 2% in 2010 (and 1% / 2% in 2011).
- It has been anticipated that consumer spending will fall, though retail sales were up 0.5% in the year to September. The squeeze on incomes, and the decline in equity withdrawal from the housing market following price falls, may depress demand. Although, house prices have risen by 1.4% over one year to October (Nationwide), recent figures have shown falling prices. Mortgage approvals are only 60% of their level two years ago. Capital Economics still expects further house price falls (15%/20%).

In summary,the recession has ended but interest rates are expected to remain low. The government was using both fiscal and monetary policy to combat the downturn, but fiscal policy will be tightened over the next five years. The recovery is expected to be slow with occasional setbacks, but sentiment has improved considerably.

3.2 Central banks have co-ordinated activity to supply liquidity to markets so that credit is available to support economic activity. It is expected that the USA economy may grow by 3% in 2010 (but only 2% in 2011) following tax cuts, interest rate cuts, and quantitative easing (QE) programmes. Improved payroll data, strong retail sales and a rebound in home construction had indicated that a recovery was underway. Recent figures have shown the recovery to be faltering, but the reintroduction of $600b in QE may support demand. It is anticipated that company earnings will also improve. It is expected that Eurozone GDP will grow by 1.5% in 2010, supported by strong growth in Germany. Growth in China and India will be around 12% and 9% respectively in 2010 – emerging market growth is strong and providing export growth to developed economes. China has raised interest rates and tightened banks' reserve requirements, while India has also raised rates. The world economy is expected to grow by 4.6% in 2010, but only 2% in 2011.

3.3 A paper on market events and future prospects, written by the Independent Adviser, is attached.

3.4 Table 1 below shows the changes in asset allocation, how asset allocation compares with the benchmark and with the average fund (WM Local Authority average), and how the change in the market value during the quarter is allocated across asset classes. Items marked (*) in columns 4 and 8 cannot be separately analysed, but are included elsewhere. The WM Local Authority average asset allocation indicates little change apart from market movements in equities.

Table 1: Asset Allocation as at 30th September compared to the Benchmark

Market (1)	Market Value 30.09.10 £M (2)	Market Value 30.09.10 % (3)	WM LA Average 30.09.10 % (4)	Fund Benchmark 30.09.10 % (5)	Market Value 30.06.10 £M (6)	Market Value 30.06.10 % (7)	WM LA Average 30.06.10 % (8)
Fixed Interest							
UK Gilts	17.4	3.8	10.6	4.5	17.1	4.0	11.0
Corp.Bonds	25.1	5.5	*	4.5	24.4	5.8	*
IL Gilts	-	-	4.8	-	-	-	4.8
Overseas	0.0	0.0	2.2	-	-	-	1.9
Emerg. Market	8.5	1.9	-	2.0	8.3	2.0	-
Infrastructure	0.9	0.2	-	-	0.8	0.2	-
Secured loans	4.3	0.9	-	2.0	8.5	2.0	-
Credit Opps.	12.0	2.7	-	2.5	11.6	2.7	-
Credit Alpha	12.3	2.7	-	2.5	10.9	2.6	-
Currency Fund	0.7	0.2			1.1	0.3	
Equities							
UK FTSE350	109.1	24.0	30.9	18.5	101.1	23.8	28.8
UK Smaller co's	15.6	3.4	*	4.0	14.5	3.4	*
Overseas	105.9	23.3	34.5	26.5	98.5	23.2	34.3
USA	49.9	11.0	9.7	-	51.8	12.2	11.6
Europe	25.5	5.6	9.4	-	17.6	4.2	9.5
Japan	7.7	1.7	3.5	-	6.9	1.6	4.2
Pacific	9.4	2.1	4.3	-	8.6	2.0	4.3
Other	13.4	2.9	5.9	-	13.6	3.2	6.0
Other							
Property – UK	23.8	5.2	6.2	8.0	22.5	5.3	6.8
Property – Eu.	6.6	1.5	*	*	6.1	1.4	*
Hedge funds	41.1	9.0	2.0	10.0	40.7	9.6	2.6
Private Equity	41.7	9.2	2.8	8.0	38.2	9.0	3.4
GTAA	12.7	2.8	1.3	4.0	9.9	2.3	1.2
Infrastructure	4.6	1.1	*	2.0	5.1	1.2	*
Cash	11.8	2.6	4.0	1.0	5.3	1.2	4.0
Total	**454.1**	**100.0**	**100.0**	**100.0**	**424.6**	**100.0**	**100.0**

3.5 The main changes to the Brent Fund have occurred as a result of market movements, agreed rebalancing and increased exposure to private equity. During the quarter, £3.5m was invested in private equity and £1m in UK property.

Since the end of the quarter there has also been further investment in UK property (£1m) and Infrastructure (£0.8m).

Performance of the Fund

3.6 The independent WM Company measures the returns on the Brent Pension Fund. Table 2 sets out returns for the quarter to 3oth September 2010.

Table 2: Investment Returns in Individual Markets

Investment Category	RETURNS						Benchmark/ Index Description
	Quarter Ending 30.09.10			Year Ended 30.09.10			
	Fund %	Benchmark %	WM Local Auth %	Fund %	Benchmark %	WM Local Auth %	
UK Equities			14.2			13.2	
UK Equities	13.7	13.7		14.0	12.6		FTSE 350
UK Small Caps	10.0	11.6		2.5	-0.6		FTSE Smallcap ex IT
Global Equities	7.7	7.6	8.2	2.1	6.3	7.9	FTSE World 75% Hedge
North America	6.2	5.7	6.2	8.4	11.9	12.1	FTSE USA
Europe	9.5	14.1	12.3	-4.9	1.6	2.9	FTSE Eu Ex UK
UK	15.5	13.7	14.2	8.4	12.6	13.2	FTSE All Share
Japan	3.1	0.5	0.1	7.6	1.2	2.3	FTSE Japan
Pacific (ex Jap)	4.5	14.8	13.6	0.5	17.5	18.2	FTSE Pac. Ex Jap
Emerging	14.9	12.1	12.2	18.0	23.3	21.8	FTSE World (Other)
Fixed Interest							
Total Bonds	4.2	2.6	4.3	9.9	5.7	10.6	Brent benchmark
UK Bonds	3.8	3.6	-	4.2	3.8	-	FTSE UK over 15 years
Index Linked UK	-	-	4.0	-	-	9.7	-
Corp Bonds	5.1	4.8	-	10.4	11.5	-	iBoxx Sterling Non-gilt
Secured Loans	4.5	0.9	-	15.1	3.7	-	3 month LIBOR +3%
Credit Opportunities fund	3.7	1.4	-	11.7	5.7	-	3 month LIBOR+5%
Other							
UK Property FOF	1.9	2.2	2.3	22.1	22.6	17.6	IPD Pooled index
Eu Property FOF	8.0	1.9	-	-7.4	8.0	-	IPD All properties
Hedge Funds	0.9	1.1	2.1	1.0	4.5	6.6	3 month LIBID+4%
Private equity	2.3	0.1	2.7	8.0	0.4	9.9	LIBID 7 Day
Infrastructure	-0.1	1.1	-	-3.0	4.4	-	3 Month LIBID +4%
GTAA	27.8	13.8	-	25.3	11.8	-	FTSE 100
Cash	0.8	0.1	1.5	n/a	2.4	3.0	GPB 7 DAY LIBID
Total	**7.1**	**6.3**	**8.5**	**7.9**	**7.8**	**11.3**	

3.7 Details of individual managers' performance tables are attached in Table 3, which shows three month, one year and longer-term information. Returns for the quarter outperformed the benchmark by 0.8%. Part of the outperformance arose as a result of asset allocation (overweight equites). The main stock selection factors were:-

a) Fixed interest. Both the core and satellite portfolios outperformed. The core portfolio benefitted from falling yields as markets anticipated further quantitative easing. The satellite fund rose in value as markets recoverd confidence in the credit worthiness of companies, and as the manager was able to add value through active trading.

b) GTAA. The manager outperformed sharply as three of the four strategies added value. In equities, additional (long) exposure to UK and short

exposure to Japan were helpful. In currencies, the overweight to higher yielding currencies added value, as did the short on the dollar. In bonds, the long positions in Japan and USA, and short in Europe, also helped.

c) Property. In European property, returns were helped by the euro recovering value. The european market has begun to improve, and the manager is looking for new funds to commit cash.

d) Hedge funds. Fauchier continue to struggle as markets are heavily correlated and looking at the benefits of quantitative easing. The manager has reduced their allocation to equity long/short managers (and increased exposure to event driven strategies), but is waiting for fundamentals to reassert themselves.

3.8 Over one year, the Fund outperformed the benchmark by 0.1%. Asset allocation – lower exposure to UK Small companies and overseas equities, higher exposure to bonds and cash (held to fund the Infrastructure mandate) - has been negative. Stock selection added value – UK equities, bonds, GTAA and private added value.

3.9 The relative underperformance of the Brent fund against the WM Local Authority average in Q4 (-1.4%) arises as a result of asset allocation - low exposure to equities / high exposure to alternative investments.

3.10 The Brent fund has underperformed the average local authority fund by 3.4% over one year, mainly because it has had a lower exposure to equities (higher exposure to alternatives – mainly hedge funds and private equity) in a period when equities have performed very strongly. Relative performance has also suffered as a result of reduced returns in global equities.

Actions taken by the Brent In-House UK Equity Manager during the Quarter

3.11 There has been some purchases and sales during this quarter to invest dividends (£0.9m) improve tracking error and invest in private equity.

<u>Purchases</u>

a) Took up rights issues.
b) To reduce tracking error.

<u>Sales</u>

a) Sold stocks to ensure more accurate index tracking or as they left the index (such as Edinburgh Dragon Trust).
b) Sold stocks to fund investment elsewhere or to pay retirement lump sums.

Future Strategy for the UK FTSE350 Index tracking fund

3.12 The strategy is that of tracking the FTSE 350 within 0.5% over the year. Activity during October and November included selling stocks to fund increased exposure to property and infrastructure, and to pay retirement lump sums to staff.

NEW DEVELOPMENTS AND FUTURE INVESTMENT OUTLOOK FOR THE BRENT FUND

3.13 Equity markets rose during October and early November in anticipation (and after) further QE in USA.

3.14 The Henderson Liquid Assets Fund (HLAF), the money market fund used by Henderson, will be managed by DB Advisors (an arm of Deutsche Bank) as from 12th October. The change has been made in response to regulators considering bringing treasury style money market funds within the scope of banking regulations – Henderson is an independent investment manager that does not seek to offer banking type products. The change will have no impact on investment strategy in the short term, but Brent will be notified if DB makes formal proposals for change. DB utilises an extensive range of cash investment instruments and has a strong reputation. Brent had £0.9m invested in HLAF as at 30th September.

3.15 The Local Government Pension Scheme (LGPS) is currently under review by John Hutton, following a long period of rising costs and negative publicity. Two recent announcements have helped funding levels – the switch from RPI to CPI will reduce inflation related payments to pensioners, and the two year pay freeze will reduce the rise in the value of benefits. Hutto's initial findings include a career average scheme (rather than final salary related), higher employee contributions, the exploration of a hybrid defined benefit / defined contribution scheme, and a review of the pension accrual rate (currently one sixtieth per annum). The government has said that it will await Hutton's final proposals, but has announced that it will increase employee contributions on a phased basis from 2012.

3.16 Following the announcement that the head of small companies, Gervais Williams, was leaving Gartmore Investment Management, there have been further announcements of the imminent departure of the leading hedge fund manager and the chief investment officer. The stock market price has dropped sharply.Gartmore has announced that it is conducting a strategic review of the business, and is meeting interested companies with a view to a potential takeover. It is proposed that Brent will continue its existing process, but I will update members at the meeting.

4. FINANCIAL IMPLICATIONS

These are contained within the body of the report.

5. STAFFING IMPLICATIONS

None directly.

6 DIVERSITY IMPLICATIONS

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

7 LEGAL IMPLICATIONS

There are no legal implications arising from the report.

8. BACKGROUND INFORMATION

Henderson Investors – September 2010 quarter report

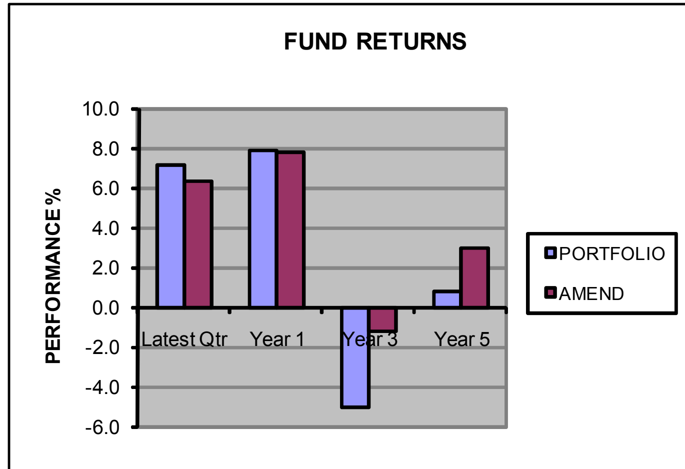
Persons wishing to discuss the above should contact the Exchequer and Investment Section, Finance and Corporate Resources, 020 8937 1472/1473 at Brent Town Hall.

CLIVE HEAPHY
Director of Finance and Corporate Services

PERFORMANCE FOR INDIVIDUAL PORTFOLIOS 30th SEPTEMBER 2010

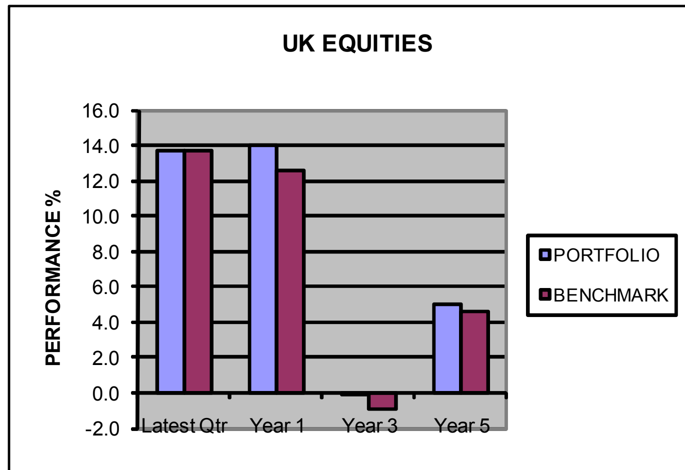
FUND RETURNS

	PORTFOLIO	BENCHMARK
Latest Qtr	7.1	6.3
Year 1	7.9	7.8
Year 3	-5.0	-1.2
Year 5	0.8	3.0



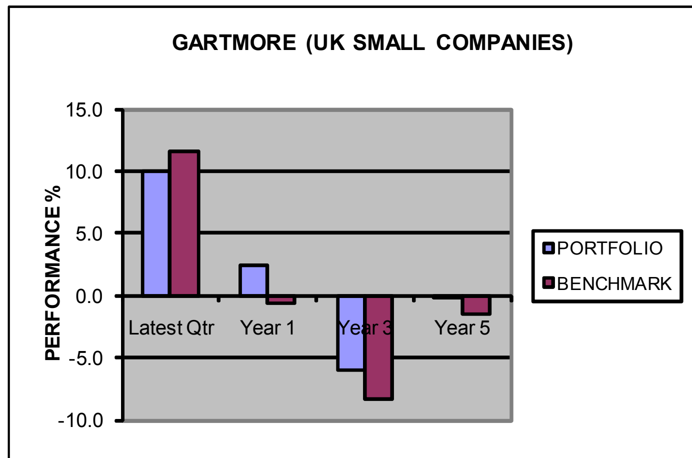
UK EQUITIES

	PORTFOLIO	BENCHMARK
Latest Qtr	13.7	13.7
Year 1	14.0	12.6
Year 3	-0.1	-0.9
Year 5	5.0	4.6



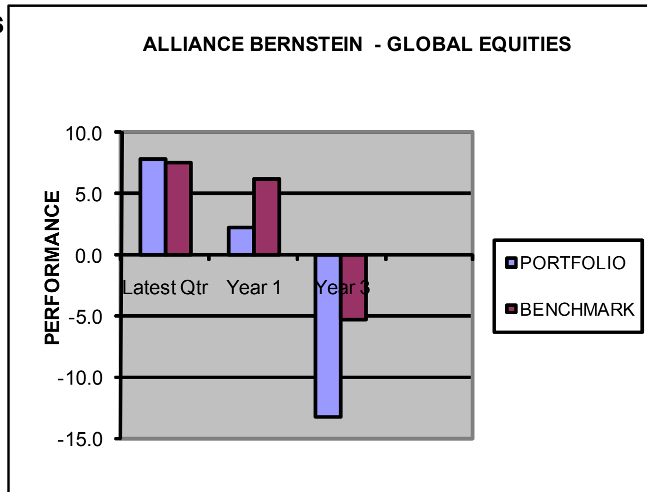
GARTMORE (UK SMALL COMPANIES)

	PORTFOLIO	BENCHMARK
Latest Qtr	10.0	11.6
Year 1	2.5	-0.6
Year 3	-6.0	-8.4
Year 5	-0.2	-1.5



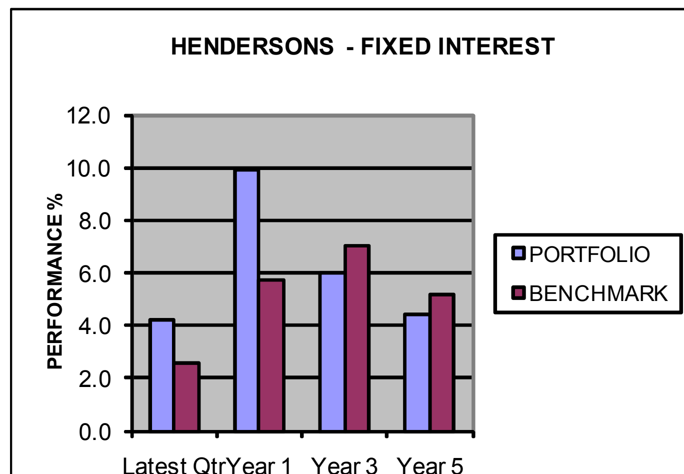
ALLIANCE BERNSTEIN - GLOBAL EQUITIES

	PORTFOLIO	BENCHMARK
Latest Qtr	7.8	7.6
Year 1	2.3	6.3
Year 3	-13.2	-5.2



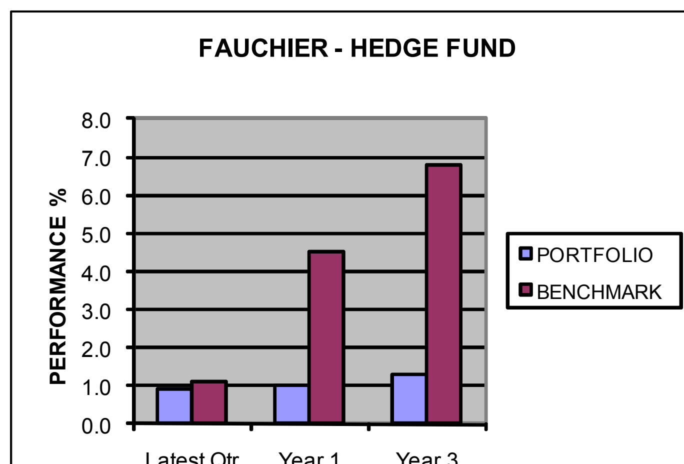
HENDERSONS - FIXED INTEREST

	PORTFOLIO	BENCHMARK
Latest Qtr	4.2	2.6
Year 1	9.9	5.7
Year 3	6.0	7.0
Year 5	4.4	5.2



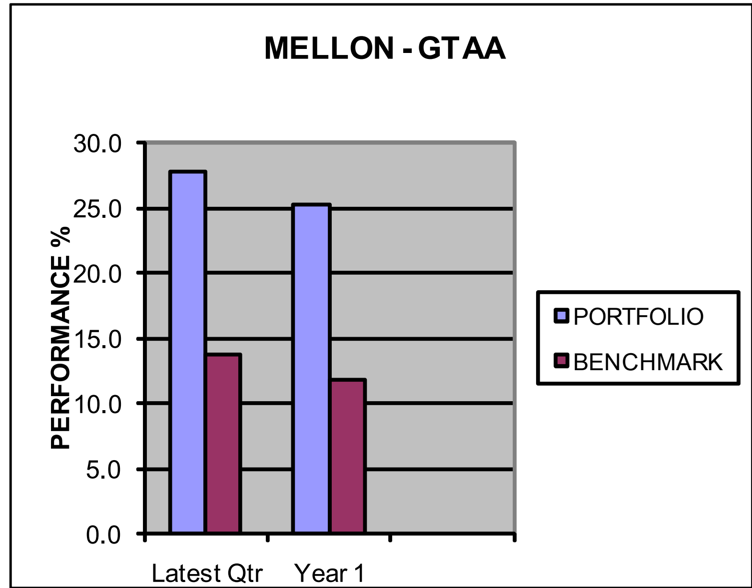
FAUCHIER - HEDGE FUND

	PORTFOLIO	BENCHMARK
Latest Qtr	0.9	1.1
Year 1	1.0	4.5
Year 3	1.3	6.8



MELLON - GTAA

	PORTFOLIO	BENCHMARK
Latest Qtr	27.8	13.8
Year 1	25.3	11.8



Report from the Independent Adviser

Investment Report for the Quarter ended 30th September 2010

Market Commentary

Index returns expressed in sterling

	Indices	Q/E 30.09.10
		%
Equities		
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	15.0
UK	FTSE All Share	13.6
Europe	FTSE Developed Europe (ex UK)	13.4
Emerging Markets	MSCI Emerging Markets Free	12.2
North America	FTSE North America	5.8
Japan	FTSE Developed Japan	0.1
Fixed Interest		
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	4.8
UK ILGs	FTSE British Government IL Over 5 years	4.1
UK Gilts	FTSE British Government All Stocks	3.6
Property	IPD	Not available
Cash	Merrill Lynch LIBOR 3 Month	0.1

Currency Movements for the quarter ended 30th September2010

Currency	30th June 2010	30th September 2010	Change %
USD/GBP	1.496	1.576	5.3
EUR/GBP	1.221	1.154	-5.5
USD/EUR	1.225	1.365	11.5
YEN/USD	88.490	83.450	-5.6

In strict contrast to the markedly negative equity returns of the previous quarter, those for the reported quarter brought some welcome cheer to stockholders in all equity markets. Highest on the leader board was the 15.0% return from the Asia/Pacific region – scarcely surprising in view of the buoyant underlying economic growth of its member nations. It was heartening to see that second was the UK, up a robust 13.6%. A strong turnaround from its 11.8% negative return in the previous quarter. Both Europe (+13.4%) and Emerging Markets (+12.2%) staged powerful recoveries despite the former's problems with the deficits of Greece and Ireland. The return from the USA (+5.8%) would most probably have been higher, but for the deteriorating economic conditions besetting President Obama's Democratic Party. Japan, as so often in the past, was at the bottom of the pack, recording a minuscule 0.1% return, a reflection of the political squabbling and power struggle for the post of prime minister together with the increasing lack of investor patience.

All three sub sectors of Fixed Interest were in positive territory, but could in no way be compared with the returns from equities. The strongest return came from Corporate Bonds (+4.8%) with the obvious attraction of their high yields. Both Index Linked Gilts (+4.1%) and pure Gilts (+3.6%) produced very creditable returns, boosted by safe haven investors. As a consequence the yields on these sub sectors of Fixed Interest were driven down to levels which could not have been envisaged earlier in the year.

In general market sentiment improved over the quarter due to the following beneficial influences:-

- The historically very low returns on cash deposits caused both institutional and private investors (some of whom were holding much higher levels of liquidity than usual) to take advantage of attractive equity valuations, particularly those with a high yield and a substantial proportion of corporate earnings emanating from overseas. This applied not just to UK investors, but also international investors as they sought to further increase globalisation in their portfolios.
- A sharp upturn in the use of shipping container transport. This is usually a reasonably reliable barometer of the state of the global economy. This was also borne out by the World Trade Organisation reporting that the value of world trade in the first half of 2010 expanded at a substantial annualised rate of 25.0%.
- Fears of rising inflation levels diminished as the measures taken by both governments and central banks appeared to introduce greater control. Worryingly, however, the Bank of England proved an exception with inflation levels well over the government's 2.0% target.
- As the end of the quarter approached and it seemed that equities would most likely achieve strong returns, this caused institutional investors to be involved in a certain amount of "window dressing", not wishing to be seen to be holding too high levels of cash at the quarter end.
- Corporate earnings and dividends were mostly better than investment analysts had been expecting. However, accompanying statements were generally cautiously optimistic.
- Across the globe most governments and central banks maintained their interest rates at extremely low levels, particularly those nations in the Western Hemisphere. However, certain Eastern Hemisphere central banks actually increased their rates in order both to guard against their rapidly growing economies becoming overheated and also to pre-empt the likelihood of rising inflation. Of course, the paradox for those countries with fast growing economies was to protect their vital export trade by attempting to stop their currencies from surging. Indeed, in that regard, it is almost as if respective central banks vied with each other to keep currency levels low in order for their exports to remain competitive in the international market place.
- The perception that governments were attempting to better control their respective banking systems and to make practices far more transparent with a higher degree of regulation.
- The continuance of much needed deleveraging both amongst the banks and industry as a whole.
- Tentative signs that the world's financial systems were becoming more liquid which should be a stimulus to improving bank lending.
- And finally, the most important , very few signs amongst the industrialised nations of their economic activity falling back into recession (with the obvious exception of some of the smaller and highly indebted Eurozone countries). Whilst most countries managed to increase their rates of GDP growth the growth rates of some of the Western Hemisphere countries were anaemic indeed.

Within the leading global economies the principal factors affecting the course of equities, fixed interest and other asset classes were as below:-

- In the UK, the coalition government experienced a surprisingly calm honeymoon period as it began its programme to reduce the fiscal deficit. Company results and exports were better than expected. There was a re-emergence of merger and acquisition activity together with an increase in buyouts within private equity, but residential property prices weakened.
- In the USA, President Obama came under constant attack for the Democratic Party's economic policies which caused consumers' morale to fall as they worried both about job security and collapsing house prices. The imminence of the mid term elections on November 2nd prayed on the White House as there was increasing concern that the Democrats might lose their majority both in the House of Representatives and also in the Senate which would considerably weaken Obama's ability to enact strong legislation.
- In Europe, economic growth continued at two speeds with Germany (the powerhouse of the Eurozone) and the Nordic countries growing rates of GDP relatively strongly whilst Greece, Ireland, Portugal and Spain experienced either very weak economic growth or even recession. Trichet, the head of the European Central Bank, did a creditable job of holding the Eurozone together.
- In Asia/Pacific and Emerging Markets, rates of GDP growth continued at a generally very strong pace, headed inevitably by China. Considerable inter regional trade took place with less of a reliance on exports to the USA and Europe. There was evidence that China is at last prepared to bend to international pressure in order to revalue its currency the renminbi. It is attempting to effect this without too much loss of face. The Australian economy continued to be strong on the back of its mineral wealth. It even had to increase interest rates to pre-empt a rise in inflation.
- In Japan, it came as little surprise that the economy continued to be adversely affected by its deflationary past. Furthermore, politics continued to be an adverse influence with infighting within the elected Democratic Party over the role of prime minister. Neither was Japan's economy helped by the continuing strength of the Yen, particularly against the US dollar. Fundamentally, it would appear that Japan's culture is having difficulty in embracing modern capitalism.

UK

Positive Influences

- August retail sales grew by 2.8% p.a.
- Export volume in the second quarter rose by a substantial 15.5% due to sterling's depreciation.
- The fiscal budget deficit is proving to be lower than expected due to healthy corporate profits translating into higher tax revenue.
- The rate of July's CPI inflation slipped to 3.1 % from June's 3.7%.
- The number of people employed surged by 184,000 to 29.02M in quarter two, the biggest rise since 1989.

Negative Influences

- The Bank of England official estimates of GDP growth were 1.6% in 2010, 2.7% in 2011 and 3.1% in 2012. These were lower rates than the Bank had estimated in May of 1.7%, 3.4% and 3.5% respectively.

- Imports exceeded exports by £13.2B in the quarter to 31st July representing the largest deficit since records began in 1946.
- The purchasing managers' index for the manufacturing sector for August decreased to 54.3 from 56.9 in July.
- In August the stock of unsold houses rose by 41.3% p.a.
- The Bank of England reported that August mortgage approvals fell to 45,000 from July's 47,000.
- On 11th August the Bank of England warned that although inflation will continue to be over target the Bank is unlikely to toughen monetary policy.

USA

Positive Influences

- On 21st September the FED stated that it was "prepared to provide additional accommodation if needed to support the economic recovery". This appeared to be a signal for another programme of quantitative easing.
- The private sector created 235,000 jobs in the quarter to 31st August.
- The Conference Board's confidence index rose to 53.3 in August from 51.0 in July. This was better than economists expected.
- The purchasing managers' index increased to 56.3 in August compared with 55.5 in July.
- The Commerce Department reported that August housing starts rose by 10.5%, a much higher level than expected.
- On 11th August, in a further monetary easing programme, the FED said that it would purchase $18B of Treasury Bonds over the next month.
- Durable goods orders in August rose 2.0% against consensus economists' forecasts for an increase of 1.0%.

Negative Influences

- On 10th August the FED held interest rates and stated that it would continue to hold rates for an extended period. The FED added "the pace of recovery in output and unemployment has slowed in recent months and is likely to be more modest than anticipated in the near term".
- On 3rd September President Obama said "there is no quick fix to the worst recession we've seen since the Great Depression". He added "the economy is moving in a positive direction, jobs are being created, they are just not being created fast enough given the big hole that we've experienced".
- On 8th September the "Beige Book" reported "widespread signs of a deceleration" in growth during August.
- The August unemployment rate inched up to 9.6% (July 9.5%)
- The second quarter's rate of GDP growth was revised down to 1.6% from 2.4%, partly due to a 32.4% p.a. rise in imports, the largest increase for 26 years.
- The ISM index of national services activity decreased to 51.5 in August, down from July's strong showing of 54.3.

Europe

Positive Influences

- 27 member countries of the Basel Committee on Banking Supervision agreed that banks will have to triple core tier one capital ratios from 2% to 7% by the year 2019. This ratio measures the highest quality assets that banks hold against future losses.
- On 7th September the Swiss Franc rose to a record 1.2840 versus the euro.
- On 13th September the European Commission estimated that Eurozone GDP will grow at 1.7% in 2010, up from estimates of only 0.9% in May. This is largely as a result of the second quarter GDP rise of 1.0%. For 2011 the ECB's estimate is 1.4% versus 1.2% earlier.
- Sweden's government estimates that the country's GDP growth rate is set to reach 4.5% in 2010. The Riksbank of Sweden raised interest rates by ¼% to ¾% in the expectation of strong economic growth.
- On 5th August Mr Trichet of the ECB said that at the present time he was sending "absolutely no signal of change in interest rates". On 2nd September Trichet said he expects "positive underlying momentum" in the Eurozone economy and that he ruled out "a double dip back into recession".
- On 25th August Germany's IFO Institute business climate index was the highest since June 2007.
- The Bundesbank estimates German economic growth of 3.0% in 2010 versus its previous estimate of 2.0%. German GDP grew by a robust 2.2% in the second quarter compared with estimates for a rise of 1.3%. This was due to better than expected domestic and foreign demand.
- France's second quarter GDP growth was a better than expected +0.6% due to businesses buying to invest and build up stocks again.
- The Italian Treasury estimates that GDP in 2010 will grow by 1.2% versus its previous estimate of 1.0%. It estimates a growth rate of 1.3% for 2011 against its previous estimate of 1.5%.

Negative Influences

- Germany's leading banks need to raise up to €105B of extra capital under a global regulatory overhaul.
- German orders for July decreased by 2.2% (June +3.6%).
- The Eurozone's composite purchasing managers' index, covering both the manufacturing and service sectors, slipped to 56.1 in August from 56.7 in July. Germany's PMI index was 59.3 for August compared with 59.0 for July, whilst the corresponding figures for France were 59.0 and 59.7 respectively.
- Eurozone inflation for July was 1.7% against 1.4% for June. This increase was partly due to a strong rise in energy prices.
- The Eurozone purchasing managers' index for September shrank to 53.8 from August's 56.2.
- Second quarter GDP returns for some of the weaker Eurozone countries were as follows:-

  Portugal +0.2%
  Spain +0.2%
  Greece -1.5%, its seventh quarterly contraction
- Irelands second quarter GDP fell by 1.2% compared with the first quarter's increase of 2.2%.
- It is officially estimated that the cost of saving the Irish banking system could be as high as £43B which represents more than a third of national income.

Japan

Positive Influences

- On 30th August the Bank of Japan announced an extra ¥10,000B of financing plus a ¥920B package of stimulative measures.
- On 8th September the Yen reached a 15 year high against the US dollar.

Negative Influences

- There was a damaging unsuccessful leadership challenge to the incumbent Democratic Party Prime Minister, Naoto Kan, by his rival Ichiro Ozawa.
- Second quarter GDP was a weak increase of 0.4% p.a., well below the advance of 4.4% p.a. in the first quarter.

Asia/Emerging Markets

Positive Influences

- China's industrial production for August grew by 13.9% p.a. (July +13.4% p.a.) retail sales increased by 18.4% p.a. (July +17.9% p.a.), and purchasing managers' index rose to 51.7 from July's 51.2.
- More recently China more than doubled its holdings of South Korean treasury bonds, in line with it declared policy of investing some of its foreign exchange reserves in currencies other than the US$ and the Euro. China is in the course of displacing Japan as the world's second largest economy.
- China's exports in July grew a prodigious 38.1% p.a. from +43.9% p.a. in June whilst its imports increased by 22.7% in July compared with June's rise of 34.1%.
- India's second quarter GDP recorded a strong growth of 8.8% p.a. (quarter one 8.6% p.a.). India's industrial output for July advanced a marked 13.8% p.a., nearly twice estimates of 7.7% p.a.

Negative Influences

- China's trade surplus for August decreased to $20.0B down from $28.7B as a result of booming imports. China's inflation rate increased to 3.3% in July versus 2.9% in June and compares with a target of 3.0%.
- Julia Gillard was declared Australia's new prime minister forming a centre left labour government. This will be a minority government which could pose problems in voting through essential legislation.

Conclusion

So, whither the stock markets between now and the year end? Certainly a considerable momentum has built up over the reported quarter and investor sentiment has greatly improved. Such a boost to sentiment seems well justified and likely to continue for the following principal reasons:-

- Financial systems, after rigorous purging, now seem to be under much better and more stringent controls and regulations. It appears unlikely that any more large skeletons have yet to fall out of banking cupboards.

- In relation to further recessions, there are reasons to suggest that weaker economies will experience weak rates of GDP growth. This applies especially to the UK and USA. The central banks of these countries have signalled that they are prepared to apply further quantitative easing (QE) by buying up treasury bonds. The weaker economies of the Eurozone may return to negative rates of GDP, for relatively short periods of time. It is no longer considered that higher inflation is an inevitable consequence of Q.E, but this could be wishful thinking.

- The governments of weak economies seem more prepared to grow their way out of recession rather than to inflate their way out.

- Interest rates should continue to remain at their current low levels for some time.

- Purchasing managers' indices have been trending up in most countries.

- Corporate earnings and dividends should continue to be better than expected.

- Markets have yet to fully discount the encouraging upturn in world trade. Indeed, world trade is estimated to grow by 13 ½% in 2010, higher than previously forecast. Not surprisingly, the area of greatest trade growth is expected to be within Asia. Furthermore, the International Monetary Fund is forecasting global GDP growth of 4.6% in 2010, split between 6 ½% for Asia, Emerging Markets and Brazil and 2 ½% average for the Western Hemisphere.

- The recent high levels of mergers and acquisitions, both actual and rumoured, eg BHP Billiton's bid for the Potash Corporation of Canada – also SAB Miller's bid for the Foster Group of Australia and China's alleged interest in United Biscuits here in the UK. These acquisition activities seem likely to accelerate.

- There is evidence that businesses have started to re-invest.

- Cash levels within the investing institutions are higher than normal.

It is an amalgam of all these factors which should be construed bullishly in the market place both in the UK and globally. It seems reasonable to re-iterate the forecast contained in the conclusion of the previous quarter's report - equity returns could be in the high single digit area. However, do not expect the course of markets to be smooth. There will still be periods of fear resulting in high levels of volatility and short term trading. It does seem likely that the optimistic influences mentioned above will hold sway over the negative influences of the severe fiscal deficits in the UK, USA and smaller Eurozone countries, the high rates of unemployment and the collapse of residential property prices in many countries, particularly in the UK and USA.

Comments on the future course of other asset classes are as follows:-

<u>Fixed Interest</u>

With yields on government debt having been driven to such very low levels its seems likely that the sub sector of Fixed Interest will remain flat for quite some time. Also, index linked stocks seem unlikely to make much progress with inflation rates seemingly under control, despite the continuance of quantitative easing programmes. However, corporate bonds would still seem to have further mileage on yield grounds.

Hedge Fund of Funds

Hedge fund of funds should recover from their period of poor performance, especially if market volatility increases together with less correlation between asset classes. These two elements should provide attractive opportunities thereby giving hedge fund of funds the chance of achieving positive absolute return against all market backgrounds.

Private Equity

Private equity should continue to recover from a difficult period as an increasing number of attractive opportunities emerge, in particular, corporate buy outs. Additionally there are attractions within the secondary market.

Property

Property should continue a steady recovery from the deep slump of 2008/9. However, the sub sectors offices, industrial, retail, shopping centres and residential are likely to improve at different rates. The accent on prime properties will continue to be stressed by risk averse investors. There should continue to be a pronounced trend towards globalisation in the property sector, but not towards Southern Europe at this time.

Infrastructure

The outlook for infrastructure appears to be good with an increasing number of opportunities worldwide, especially in the USA and Asia.

Other Alternatives

With regard to the remaining asset classes of Global Tactical Asset Allocation, Currency and Commodities, their results will, as usual, be extremely volatile. The performance attribution of these asset classes will have to be judged over the longer term in which these Alternative Classes should provide a pension portfolio both with a reduction in overall portfolio risk and with fundamental diversification.

In sum, it seems reasonable to predict that:-

There may be no double dip recession in either the UK or the USA.
The Eurozone is most unlikely to break up.
The worst of the banking crisis is probably over.Emerging markets and Asian markets generally will continue to outperform their Western counterparts.
Equities will continue to outperform Fixed Interest.

It follows that far sighted pension funds would be well advised to further embrace globalisation. And not just for equities and fixed interest, but also for most other asset classes be they property, private equity, hedge fund of funds or infrastructure. It goes without saying that GTAA, currencies and commodities are inherently global.

If the above forecasts are proved to be wrong it will most likely due to the following:- fiscal deficits take longer to reduce than expected; consumer spending stagnates in part due to the high rates of unemployment and the collapse of residential property; the state of the US economy deteriorates due to political impasse; or the strategy of

governments to manipulate their currencies lower in order to increase exports deteriorates into a competitive backfire.
Valentine Furniss

Investment Report for the Month of October 2010

	Indices	m/e 31.10.10
		%
Equities		
Europe	FTSE Developed Europe (ex UK)	3.1
UK	FTSE All Share	2.5
North America	FTSE North America	2.3
Emerging Markets	MSCI Emerging Markets Free	1.4
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	0.7
Japan	FTSE Developed Japan	0.4
Fixed Interest		
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	-0.4
UK Gilts	FTSE British Government All Stocks	-1.4
UK ILGilts	FTSE British Government IL Over 5 years	-1.6
Property	IPD	N/a
Cash	Merrill Lynch LIBOR 3 Month	0.1

Currency movements for month ended 31st October 2010

Currency	30th September 2010	31st October 2010	Change %
USD/GBP	1.576	1.599	+1.5
EUR/GBP	1.154	1.150	-0.3
USD/EUR	1.365	1.390	+1.8
YEN/USD	83.540	80.550	-3.6

Equity returns for the month of October continued their positive momentum from the quarter ended 30th September 2010. These returns were led by Europe (+3.1%) on the perception that the worst of the financial crises were over amongst the weaker economies of the Eurozone, particularly Greece, Ireland, Portugal and Spain. Next came the UK returning +2.5% on the perception that the government coalition was, not only holding together, but continuing to cope adequately with the problems surrounding the deep seated financial deficit. The USA recorded a 2.3% return despite the anxieties created by the imminence of the Mid Term Elections on 2nd November with the likelihood of a pronounced swing to the Republicans, particularly in the House of Representatives. The US market was also spurred by the thought that the Federal Reserve Board would almost certainly have to instigate a further tranche of quantitative easing which was assumed to be beneficial to equities. The 1.4% return from Emerging Markets resulted from the continuing popularity of this asset class, based on the presumption that the constituent countries would continue to experience strong rates of GDP growth. Asia/Pacific (+0.7%) was more subdued than usual, but still positive. In any event this region was due a pause for breath following the heady returns already achieved. And last, but definitely least, was Japan (+0.4%). As so often in the past, Japan was the laggard on the equity leader board as investors appeared to run out of patience, particularly with regard to the lack of firm government policies with which to avoid slipping back into deflation which has bedevilled this country for so long.

With regard to Fixed Interest all the principal sub sectors produced distinctly dull negative returns as investors became apprehensive concerning further central banks' monetary manoeuvring with those of the weaker economies appearing to be running out

of effective options for the resuscitation of their respective economies. The Merrill Lynch £ Non Gilts All Stocks (-0.4%) representing corporate bonds demonstrated investor apprehension that, after a strong run, there might be a degree of profit taking. Gilts (-1.4%) reflected the fact that many investors now feel that yields are low enough and therefore there is little more to go for by way of return. Inflation linked gilts (-1.6%) performed poorly, but this was scarcely surprising as they have hitherto experienced reasonable returns and it is now felt by many investors that governments and central banks have a greater control of inflation than in the past. Thus reducing the attraction of this asset class.

The IPD UK Property return is not available for October, but the return for the quarter ended 30th September 2010 is now available and was 2.3% which should be seen as respectable in the circumstances as there was still apprehension within the sector as property continued to recover, albeit at a somewhat pedestrian pace, from the acute down cycle caused by the sub prime debacle and its resultant chaos in the financial system.

The main feature of the currency movements table was the continuing strength of the Yen against the US dollar to a near record level of ¥80.550

During October general factors to affect the course of stock markets were as below:-

- The International Monetary Fund estimates that the global economy will advance by 4.8% in 2010 and by 4.2% in 2011.
- The World Steel Association estimates that global consumption of steel in 2010 will increase by a record 13.1%.
- On 13th October gold reached a record price of US$1,372 per Troy ounce.
- Currency rhetoric continued apace as the central banks of the principal industrialised nations manoeuvred to expand their vital export trade. On that score China remains somewhat of an enigma much to the chagrin of the USA. The obvious risk is that the weakness of the US$, the world's largest reserve currency, could have a destabilising effect on the world economy.

During October the principal events and macro economic data within the regions were as follows:-

UK

- The much awaited Comprehensive Spending Review was duly announced by the Government. As expected, the contents of this review made it quite clear that the UK population would suffer from harsh medicine for some four years in order to reduce the country's fiscal deficit. It was also clear that no family or individual would be untouched by the tough measures. Furthermore the Government emphasised that the country remained very reliant on private sector growth.
- Third quarter GDP grew by 0.8% (quarter two 1.2%). This was double the consensus of economists' estimates. This caused the rating agency Standard & Poors to revise its outlook on the UK's AAA rating to stable from negative. The GDP growth rate between April and September was the strongest for 10 years. Optimistically, the Chancellor of the Exchequer stated "although global economic conditions remain choppy, a steady recovery is under way".

- George Osborne, in an attempt to bolster the national exchequer funds, is to instigate a privatisation programme of the likes of the Royal Mint, the National Air Traffic Service and the Dartford Crossing.
- September retail sales fell by 0.2% versus an estimate of +0.4%.
- The purchasing managers' index for services increased to 53.2 in October from 52.8 in September whilst the corresponding index for manufacturing grew to 55.0 in October from 53.5 in September.
- The government announced that 490,000 public sector employees were to go over the next four years.
- The Office for National Statistics reported that the trade deficit for August reduced to £8.2B from £8.7B in July.
- On 12th October it was confirmed that pensioners would suffer from the switch to the inflation measure using the Consumer Price Index instead of the Retail Price Index.

USA

- GDP for the third quarter of 2010 grew at an annualised rate of 2.0%.
- September new home sales were up 6.6%.
- Durable goods orders for September rose by 3.3%. This was better than expected due to a surge in aircraft bookings.
- On 20th October the US$ fell to a 15 year low of ¥80.83 against the yen.
- In September industrial production unexpectedly fell by 0.2%.
- In October new claims for unemployment benefit rose 13,000 to 462,000.
- On 13th October the Commerce Department reported that the deficit in goods and services for September had widened by 8.7% to $46.3B.
- The Institute of Supply Management's index of non manufacturing activity rose to 54.3 in October from 53.2 in September.
- The minutes of the Federal Reserve Board meeting on 21st September showed that Bernanke has a consensus for increasing quantitative easing.
- 95,000 jobs were lost in September.
- September factory goods orders increased by 2.1%.
- Next week is a crucial one for the US economy. On 2nd November the much debated results of the Mid Term elections will be known and the extent to which the Republicans, particularly its right wing splinter group, will have affected the Democrats and the balance of power at the White House. On the 3rd November Ben Bernanke at the Federal Reserve Board will have to disclose his economic plan and whether or not to introduce another bout of quantitative easing. On 5th November the monthly jobs report will be issued.

Europe

- On 26th October the Riksbank of Sweden raised interest rates by ¼% to 1.0%.
- German industrial orders in August rose by 3.4% (July -1.6%) which was much better than expected.

Japan

- Industrial production fell by a worse than expected 1.9% in September, its fourth consecutive monthly decline.
- CPI inflation in September dropped by 1.1%.

- On 5th October the Bank of Japan introduced a package dubbed "comprehensive monetary easing" whereby it intends to hold its interest rate at virtually zero until deflation is seen to be defeated. It also intends to buy ¥500B of financial assets.

Asia/Pacific

- China's rate of CPI inflation inched up to 3.6% in September from 3.5% in August. This compares with the government's target of 3.0%.
- China's GDP for the third quarter of 2010 increased at 9.6% p.a., marginally lower than the second quarter 10.3% p.a.
- On 19th October, the People's Bank of China raised interest rates by ¼% taking the one year deposit rates to 2.5% and the one year lending rates to 5.6%. this was the first increase for almost three years.
- China's foreign exchange reserves in quarter three 2010 increased by a record $194B to a prodigious US $2650B.
- China's purchasing managers' index advanced t 54.7 in October from 53.8 in September.
- On 5th October, the Reserve Bank of Australia left interest rates unchanged at 4 ½% against consensus estimates for a ¼% rise.
- In August and September Australia created 112,000 new jobs with the unemployment rate at 5.1%, nearly half the level of the US and parts of the Eurozone.

Conclusion

Although this report is for the month of October it is being written on 5th November. So, by way of addendum we now know two important market influences both from the USA. Firstly, in the Mid Term elections on 2nd November the Republican Party trounced the Democratic Party in the House of Representatives by winning 239 seats to the Democrats' 185 seats. And in the Senate the Democrats managed to hang on by 51 seats to the Republicans' 46 seats. This represented a clear upset for President Obama which may well cause a gridlock in legislation. However, the US stock market has reacted surprisingly well . The second influential event was the announcement by the Federal Reserve Board that it is to introduce an additional quantitative easing programme of $600B with which, between now and mid 2011, it will buy US Treasury Stock. This announcement came much as expected and, here again, has been surprisingly well received by investors both in the USA and globally.

In sum, the events and macro economic data of October, do not have a material effect on the forecasts and caveats contained in the conclusion of the report for the quarter ended 30th September 2010.

Valentine Furniss
5th November 2010