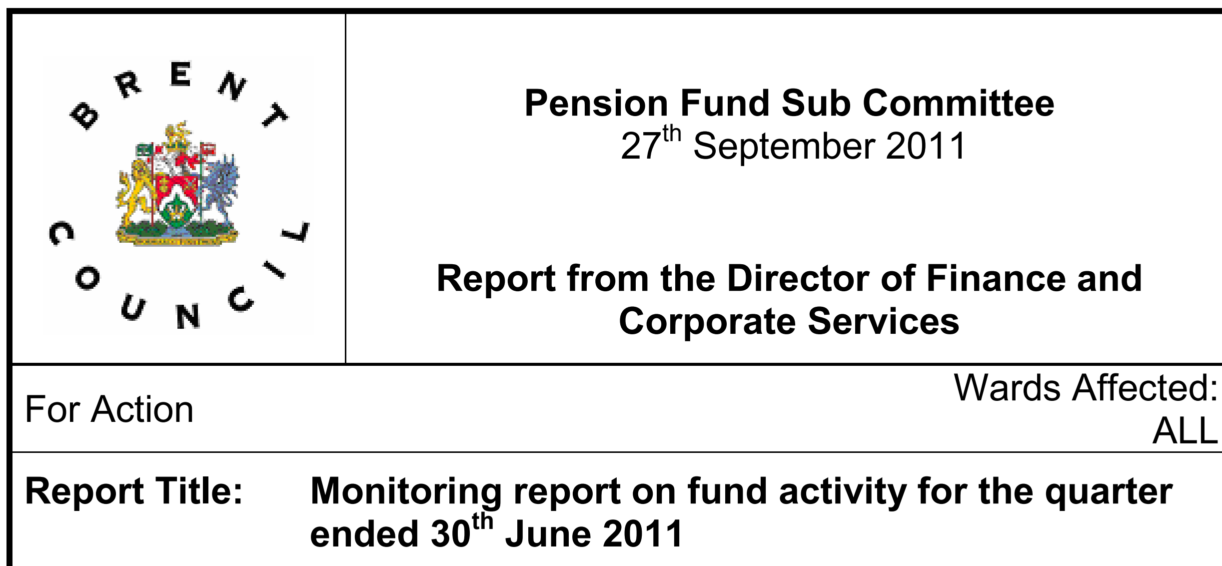


Pension Fund Sub Committee
27th September 2011

Report from the Director of Finance and Corporate Services

For Action	Wards Affected: ALL

Report Title: **Monitoring report on fund activity for the quarter ended 30th June 2011**

1. SUMMARY

This report provides a summary of fund activity during the quarter ended 30th June 2011. 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) Most markets rose during the quarter, with the exception of emerging market equities. Bonds were stronger as investors sought safety.

b) The Fund has risen in value from £486m to £494m, and has outperformed its benchmark over the quarter (+0.8%) as a result of stock selection (outperformance in bonds, UK equities, GTAA and private equity) offset by underperformance in hedge funds. The Fund marginally outperformed the return from the average local authority fund, with good returns from UK equities offset by the results of low exposure to index linked gilts. Over one year, the Fund has outperformed its benchmark (+3.3%) as a result of outperformance in all asset classes with the exception of hedge funds. Over one year, the Fund has underperformed the average fund (-1.1%) as a result of lower exposure to equities / higher exposure to alternative assets and poor performance in global equities, and hedge funds, offset by good performance in GTAA and UK equities.

2. RECOMMENDATIONS

Members are asked to note this report.

3 DETAIL

ECONOMIC AND MARKET BACKGROUND - QUARTER ENDED 30TH JUNE 2011

3.1 Equity markets were broadly stable over the quarter, despite continued market volatility. The UK, Japanese and USA markets hardly changed, Germany rose by 6%, and emerging markets fell. The UK economic background was:

- UK base rates remained at 0.5%. Medium and long-term interest rates fell marginally during the quarter. Concerns about the European banking system

and various eurozone countries (Greece, Ireland, Portugal and Spain) have affected these markets, but UK has benefited from a safe haven status.It is unlikely that rates will rise until 2012, despite inflation being above target. Markets expect rates to rise to around 2% by the end of 2013.

- Headline inflation (RPI) rose by 5.2% in the year to August (5.2% May), and the Index of Consumer Prices (CPI) rose by 4.5% (4.5% May). It is expected that inflation will rise in the short term (to around 5.5%), keeping well above the Bank of England 2% target for 2011, but should fall over a two year period as spare capacity and low pay increases bear down on prices.
- Average earnings growth (including bonuses) was 2.9% p.a. in July (2.3% March), below the Bank of England's 'danger level' (4.5%). Unemployment (claimant numbers) has risen to 1.58m, and may rise further as public expenditure is reduced and taxes raised.
- The UK economy is growing very slowly, with GDP rising by 0.2% in Q2 2011 (0.7% year on year). GDP is expected to grow by 1%/1.5% in 2011.
- Retail sales have risen by 0.1% in the year to July. The squeeze on incomes and the rising price of commodities is depressing demand. House prices have fallen by 2.6% over one year to August (Halifax). Mortgage approvals are only 60% of their level two years ago. Capital Economics still expects further house price falls (15%/20%).

In summary,the UK economy is growing at a very gentle rate but interest rates are expected to remain low. The government was using both fiscal and monetary policy to combat the downturn, but fiscal policy is being tightened over the next four years. The recovery is expected to be slow with occasional setbacks.

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 will grow by 3% in 2011 (3% 2010) following tax cuts and quantitative easing (QE) programmes, but recent data indicates that the recovery is faltering. The impact of the Japanese earthquake on world supply lines has been negative. It is expected that Eurozone GDP will grow by 1.5% in 2011, supported by growth in Germany, but increases in rates (to 1.5%) by the ECB may hit peripheral markets hard. The recent bail-out deal for Greece has reduced market tension, but there are worries about future requirements for Greece and other European states. Growth in China and India is forecast to be around 10% and 8% respectively in 2011 – emerging market growth remains strong. China has raised interest rates and tightened banks' reserve requirements, while India has also raised rates. The world economy is expected to grow by between 3% and 4% 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 increased exposure to alternative assets.

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

Market (1)	Market Value 31.03.11 £M (2)	Market Value 31.03.11 % (3)	WM LA Average 31.03.11 % (4)	Fund Benchmark 30.06.11 % (5)	Market Value 30.06.11 £M (6)	Market Value 30.06.11 % (7)	WM LA Average 30.06.11 % (8)
Fixed Interest							
UK Gilts	15.6	3.2	10.3	4.5	16.1	3.3	10.7
Corp.Bonds	24.0	4.9	*	4.5	24.5	5.0	*
IL Gilts	1.7	0.3	4.6	-	1.8	0.4	4.8
Overseas	0.0	0.0	2.6	-	-	-	2.5
Emerg. Market	8.3	1.7	-	2.0	8.4	1.7	-
Infrastructure	0.9	0.2	-	-	1.2	0.2	-
Secured loans	4.6	0.9	-	2.0	4.7	1.0	0.6
Credit Opps.	9.2	1.9	-	2.5	9.3	1.9	*
Credit Alpha	12.5	2.6	-	2.5	12.6	2.5	*
Currency Fund	0.6	0.1	-	-	0.6	0.1	
Equities							
UK FTSE350	72.8	15.0	31.1	12.5	71.4	14.4	30.9
UK Small co's	15.8	3.3	*	4.0	16.2	3.3	*
O/seas - developed	122.5	25.2	35.6	22.5	121.9	24.7	34.1
O/seas – emerging	36.6	7.5	*	8.0	35.9	7.3	*
Other							
Property – UK	26.6	5.6	6.3	8.0	27.2	5.5	6.3
Property – Eu.	6.9	1.4	*	*	7.1	1.4	*
Hedge funds	42.3	8.7	1.5	10.0	41.8	8.5	1.9
Private Equity	49.1	10.1	3.1	10.0	56.0	11.3	3.2
GTAA	18.8	3.9	1.0	4.0	19.4	3.9	1.4
Infrastructure	8.1	1.7	*	2.0	9.9	2.0	*
Cash	9.0	1.9	3.7	1.0	8.1	1.6	3.7
Total	**485.9**	**100.0**	**100.0**	**100.0**	**494.1**	**100.0**	**100.0**

3.5 The main **investment** changes to the Brent Fund have occurred as a result of market movements, sales of UK equities to fund investment (£3m), increased exposure to private equity (£3.6m), property (£0.3m, being reinvestment of dividends), and infrastructure (£1.8m). However, there have been a large number of retirements / early retirements during the quarter, resulting in lump sum payments from the Fund. Since the end of the quarter there has also been further investment in UK property (£0.3m), infrastructure (£0.2m) and private equity (£1.4m), but also more retirements.

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 30th June 2011.

Table 2: Investment Returns in Individual Markets

Investment Category	RETURNS						Benchmark/ Index Description
	Quarter Ending 30.06.11			Year Ended 30.06.11			
	Fund %	Benchmark %	WM Local Auth %	Fund %	Benchmark %	WM Local Auth %	
Equities			1.2			24.0	
UK FTSE350 Equities	3.0	1.9	2.2	27.3	25.6	26.7	FTSE 350
UK Small Caps	2.0	2.4		30.4	24.6		FTSE Smallcap ex IT
Overseas - developed	-0.4	-0.4	0.4	19.6	19.1	22.0	FTSE World 75% Hedge
Overseas - emerging	-1.9	-1.8	-2.3	-	-	-	FTSE AW - All emerging
Fixed Interest							
Total Bonds	1.8	1.6	2.8	6.2	4.0	6.6	Brent benchmark
UK Bonds	2.5	2.5	2.0	3.5	3.1	5.3	FTSE UK over 15 years
Index Linked UK	-	-	4.6	-	-	9.8	-
Corp Bonds	1.7	1.9	-	5.6	5.2	-	iBoxx Sterling Non-gilt
Secured Loans	1.4	1.0	-	13.8	3.7	-	3 month LIBOR +3%
Credit Opportunities fund	1.1	1.4	-	7.5	5.7	-	3 month LIBOR+5%
Other							
UK Property FOF	2.3	2.1	2.0	12.5	10.7	8.9	IPD Pooled index
Eu Property FOF	2.7	1.9	-	17.8	8.0	-	IPD All properties
Hedge Funds	-1.1	1.2	0.1	2.8	4.6	6.0	3 month LIBID+4%
Private equity	7.9	0.1	4.4	16.8	0.4	15.6	LIBID 7 Day
Infrastructure	1.7	1.2	-	6.2	4.6	-	3 Month LIBID +4%
GTAA	3.0	1.6	-	50.8	24.9	-	FTSE 100
Cash	0.8	0.1	0.5	3.5	0.4	2.1	GPB 7 DAY LIBID
Total	**1.6**	**0.8**	**1.5**	**16.7**	**13.4**	**17.8**	

3.7 Table 3 illustrates returns over three months, one year and three years. Returns for the quarter outperformed the benchmark by 0.8%, following outperformance in bonds, UK equities, GTAA and private equity, offset by underperformance in hedge funds. The main stock selection factors were:-

a) Fixed interest. The core portfolio underperformed the benchmark mainly as a result of the overweight to corporate bonds (which underperformed government gilts). The satellite portfolio outperformed as secured loans and emerging market debt investments added value. Henderson are cautious about markets, keeping around 10% of the portfolio in money market funds.

b) GTAA. The manager outperformed in April and June. Three strategies added value for the quarter as a whole, but the stock / bond strategy lost value as bonds outperformed equities. In equity allocation (stock / stock), long exposure to UK and short exposure to HongKong added value. In currency, short exposure to sterling was the largest contributor. The bond market allocation (bond / bond) added value through overweighting US and Australian bonds.

c) Property. In the UK, there have been new entrants to the Fund, allowing the manager to purchase assets at a discount. The UK property market is performing better than expected as overseas investors see UK as a sound market and UK investors look for income yields. Outperformance has arisen as a result of above average exposure to the City and West End of London Property markets, leisure and student housing. In European property, returns rose. The European market has begun to improve, and the manager

is finding new funds in which to commit cash. However, the investment in Portugal is struggling, and the manager is reducing exposure.

d) Hedge funds. It is understood that many hedge fund managers are struggling in the current financial climate where policial factors are driving markets. Fauchier report that underperformance derives from a group of managers who have outstanding long term records but are waiting for markets to reflect their views. A separate report has been prepared.

3.8 Over one year, the Fund outperformed the benchmark. Stock selection added value – UK equities, UK Small Cap, bonds, GTAA and private equity outperformed the benchmark, while hedge funds underperformed.

3.9 The Brent fund marginally outperformed the WM Local Authority average for the quarter as favourable asset allocation offset relative underperformance in bonds, overseas equities (the effects of the currency hedge) and hedge funds.

3.10 The Brent fund has underperformed the average local authority fund by 1.1% 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 strongly. However, there has been outperformance in UK equities and GTAA, partially offset by underperformance in overseas equities and hedge funds.

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

3.11 The main activity during the quarter was further action to rebalance the portfolio so that tracking error was reduced following the transfer to LGIM. This has involved selling FTSE 250 stocks. There have also been some purchases and sales during this quarter to invest dividends (£0.9m), improve tracking error, pay retirement lump sums, and invest in private equity.

Purchases

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

Sales

a) Sold stocks to ensure more accurate index tracking or as they left the index.
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 July included buying and selling stocks to improve tracking error, to invest dividends and to fund lump sums.

NEW DEVELOPMENTS AND FUTURE INVESTMENT OUTLOOK FOR THE BRENT FUND

3.13 Markets fell marginally in July, before falling sharply in August. The problems of the USA borrowing limit and growth, Greek and European debt, and slowing growth, continue to weigh on sentiment. Equity markets have fallen by around 15%. Property and bond markets remain firm as investors seek safety – bond

yields continue to fall, and prices to rise. The hedge fund manager has outperformed equities sharply during August as hedging techniques preserve (most) value.

3.14 The transfer of emerging market equity investment from LGIM to Dimensional Fund Advisers occured early in July.

3.15 As The infrastructure manager, Alinda, continues to invest in new assets and improvements to the assets owned. The Fund has invested in water treatment (sewerage), container terminal facilities, shale gas pipelines, an internet communications network, and car parking facilities. With the exception of the container terminal facilities, the invesments are in USA.

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 – June 2011 quarter report
Legal & General – June 2011 quarter report
Fauchier Partners – June 2011 quarter report
Persons wishing to discuss the above should contact the Exchequer and Investment Section, Finance and Corporate Services , 020 8937 1472/1473 at Brent Town Hall.

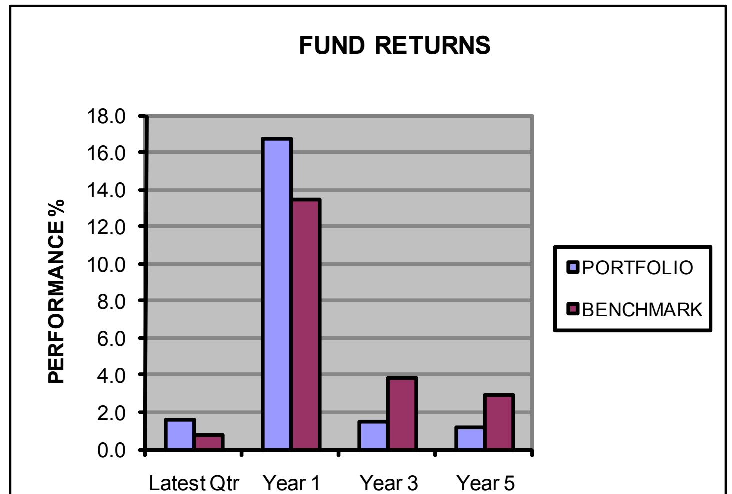
CLIVE HEAPHY
Director of Finance & CS

MARTIN SPRIGGS
Head of Exchequer and Investment

TABLE 3: PERFORMANCE FOR INDIVIDUAL PORTFOLIOS 30th JUNE 2011

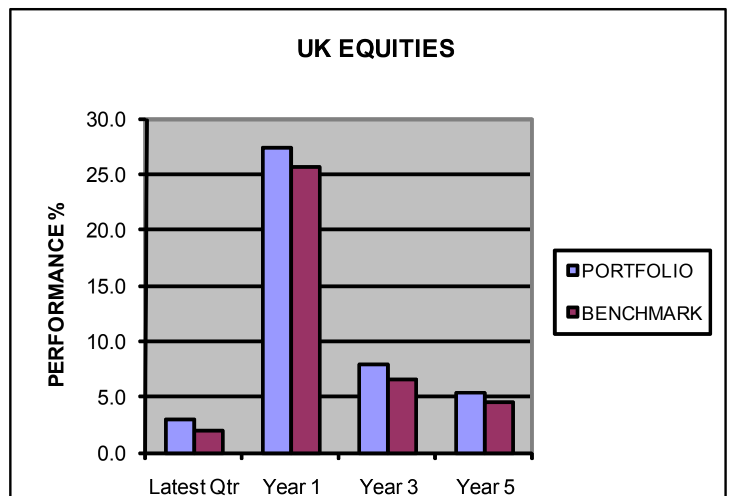
FUND RETURNS

	PORTFOLIO	BENCHMARK
Latest Qtr	1.6	0.8
Year 1	16.7	13.4
Year 3	1.5	3.8
Year 5	1.2	2.9



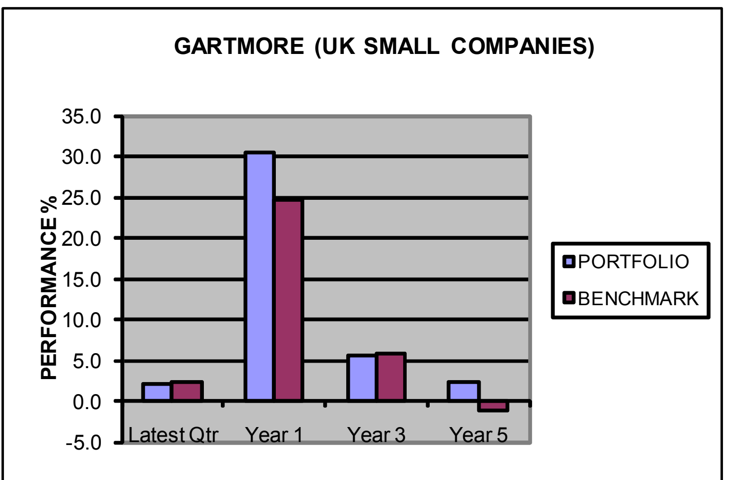
UK EQUITIES

	PORTFOLIO	BENCHMARK
Latest Qtr	3.0	1.9
Year 1	27.3	25.6
Year 3	8.0	6.6
Year 5	5.3	4.6



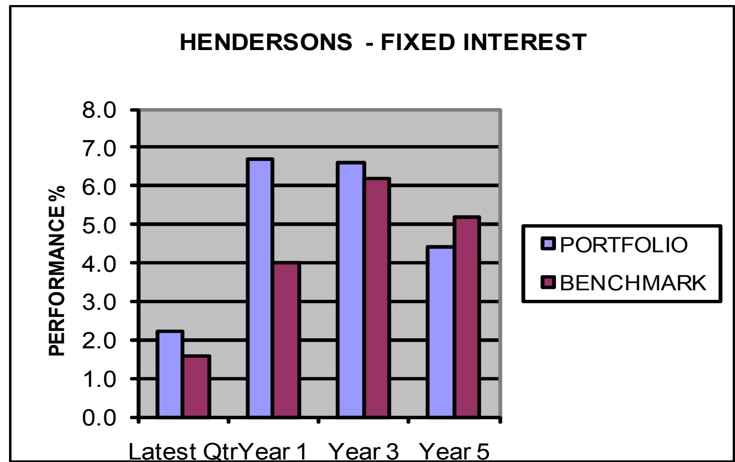
GARTMORE (UK SMALL COMPANIES)

	PORTFOLIO	BENCHMARK
Latest Qtr	2.0	2.4
Year 1	30.5	24.6
Year 3	5.6	5.8
Year 5	2.4	-1.1



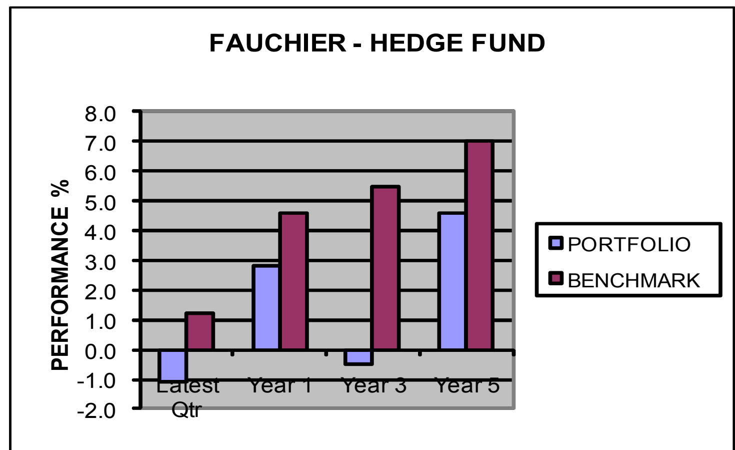
HENDERSONS - FIXED INTEREST

	PORTFOLIO	BENCHMARK
Latest Qtr	2.2	1.6
Year 1	6.7	4.0
Year 3	6.6	6.2
Year 5	4.4	5.2



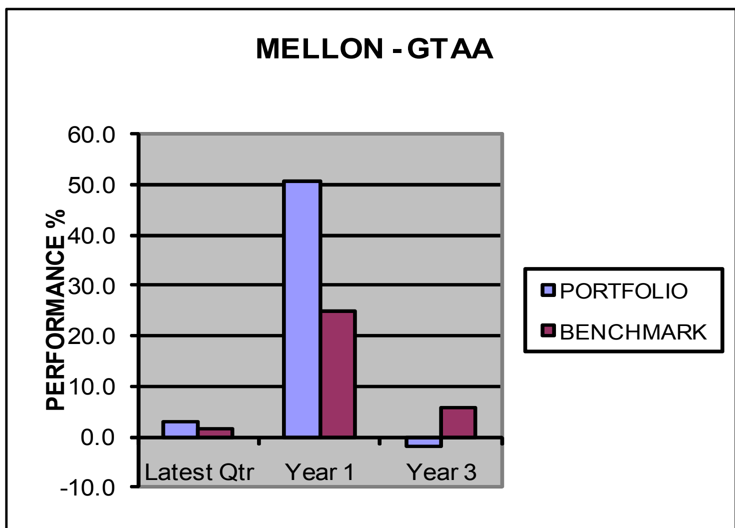
FAUCHIER - HEDGE FUND

	PORTFOLIO	BENCHMARK
Latest Qtr	-1.1	1.2
Year 1	2.8	4.6
Year 3	-0.5	5.5
Year 5	4.6	7.0



MELLON - GTAA

	PORTFOLIO	BENCHMARK
Latest Qtr	3.0	1.6
Year 1	50.7	24.9
Year 3	-1.9	5.8



Report from the Independent Adviser

Investment Report for the Quarter ended 30th June 2011

Market Commentary

In a word, the greatest influence on the direction of markets during the quarter was investor apprehension both within the UK and globally. The principal constituents and grounds of this apprehension were as follows:-

- The return of fears within the Eurozone that their could be a further round of corrosive contagion centred on the peripheral countries, particularly Greece which appears to be suffering from an increasingly dysfunctional political system and central bank both of which seem quite incapable of applying the necessary remedial austerity measures with sufficient vigour. The degree to which other Eurozone countries are invested in Greek bonds is higher than was first thought. No wonder that the Euro has been battered.

- In the UK, the economy has continued to be buffeted by high inflation (partly as a result of earlier quantitative easing programmes), together with a high rate of unemployment and weak consumer spending. The policies of the Coalition Government have come under increasing scrutiny as they and the Bank of England strive to maintain measures both to reduce the nation's substantial deficit and to improve the morale of consumers whose spending is estimated to account for approximately two thirds of the economy. In a more hopeful vein, it is just as well that corporate earnings and dividends have, on the whole, continued to be better than expected.

- The American market was absorbed by the game of political brinksmanship between the Democrat and Republican parties to agree a meaningful deficit reduction programme and to avoid certain states becoming effectively bankrupt. This most worrying state of affairs was also not helped by the two parties jockeying for position ahead of the second term presidential elections next year.

- Within Asia, unsurprisingly the dominant nation continued to be China with a manic market focus on its various manoeuvrings on the world scene in order to secure future supplies of energy and minerals and also to ensure that its currency remained sufficiently competitive to further boost its export growth. On the domestic front the government concentrated upon the containment of inflation whilst keeping a careful eye on the booming property market lest it develop into a bubble.

- In Japan, the weak government, under prime minister Kaoto Kan, continued to grapple with the aftermath of the devastating earthquake and tsunami and to ensure, above all else, that the fragile economy did not slip back into the mire of deflation.

The index returns and currency movements for the quarter ended 30th June 2011 are shown in the tables below.

Index returns expressed in sterling

		Q/e 30th June 2011
		%
Equities		
Europe	FTSE Developed Europe (ex UK)	3.2
UK	FTSE All Share	1.9
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	0.4
Japan	FTSE Developed Japan	0.2
North America	FTSE North America	-0.4
Emerging Markets	MSCI Emerging Markets Free	-1.2
Fixed Interest		
UK Index Linked Gilts	FTSE British Gov. Index Linked Over 5 years	4.5
UK Gilts	FTSE British Government All Stocks	2.5
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	1.9
***Property**	IPD	Not available
Cash	Merrill Lynch LIBOR 3 Month	0.4

* The IPD index return from 28th February to 31st May 2011 was 2.3%.

Currency Movements for quarter ended 30th June 2011

Currency	31st March 2011	30th June 2011	Change %
USD/GBP	1.603	1.605	0.2
EUR/GBP	1.130	1.107	-2.0
USD/EUR	1.419	1.450	2.2
YEN/USD	82.880	80.760	-2.6

Equity returns were led by Europe (+3.2%) which is a particularly resilient performance both in the light of its 5.4% return in the previous quarter and the continuance of a most unsettled background within the Eurozone. Next came the UK (+1.9%) which was also resilient in view of the harshness of the Coalition government's austerity programme. The Asia/Pacific return was a muted (+0.4%) as investors became unsettled by the possibility that the economic growth of China might be slowing with the harmful effect that this might have within the whole Asia/Pacific region. The return for Japan was barely positive (+0.2%) as the country struggled from the aftermath of its natural disasters. North America disappointed with a negative (-0.4%) as the Government and the Federal Reserve wrestled with the acute deficit. Emerging markets disappointed with a negative (-1.2%) return as investors tended to shy away from countries that were perceived to be higher risk during a time of economic and financial turmoil.

The Fixed Interest sector earned its place as a sector of sanctuary and a form of portfolio insurance against the vagaries of the equity market. In particular, Index Linked Gilts returned 4.5% and achieved their raison d'etre of producing a return to match inflation. Gilts produced a 2.5% return, despite forecasts that the next move in interest rates would be up, but probably not until much later in the year. Corporate bonds achieved an acceptable 1.9% return thanks to the relatively high yields and security that they offered. In general, it has to be said that the above results, whilst relatively modest, were appreciably higher than could have been envisaged in the early part of the quarter.

UK

Positive Influences

- The Office for Budget Responsibility forecasts a further improvement in tax receipts for the remainder of the fiscal year and estimates that business investment will rise by 6.7% for 2011. The Office also still estimates that GDP will grow by 1.7% in 2011. This seems unrealistically high.
- The London Stock Exchange is experiencing the strongest pipeline of Initial Public Offerings for 5 years.
- Wen Jiabao, China's premier, on a goodwill visit to the UK, signed off some substantial trade deals.

Negative Influences

- May inflation was unchanged at 4.5%, partly due to a marked rise in food prices. The Bank of England had estimated that inflation would be 4.5% for the first quarter of the 2011 rising to 5.0% in the ensuing quarter, due to expected rises in utility charges in the range 10 to 15%.
- There is evidence to show that re-mortgagees are have difficulty. As a result an increasing number of people are having to opt for renting. The Bank of England said that mortgage approvals for house purchasers receded to 45,166 in April from 47,145 in March.
- Moody's, the rating agency, have warned that the UK could lose its top tier credit status if economic growth continues to slow.
- The British Retail Consortium reported that retail sales in May fell 0.3%. However, whilst retail spending has been flat, online shopping has been buoyant.
- The Institute of Supply Management's purchasing managers' index showed a sharp drop to 53.5 in May compared with the 60.4 recorded in April.
- Household spending, which accounts for almost two thirds of the economy, decreased by 0.6% in the first quarter of 2011.
- Mervyn King at the Bank of England stated "there is no doubt we are facing a difficult time ahead with a slow adjustment to the financial crisis".
- The National Institute of Economic and Social Affairs reduced its estimate of GDP by 0.1% to 1.4% for 2011 blaming, in part, higher oil prices.
- The Bank of England's Monetary Policy Committee's minutes for June indicate that it might favour a further round of quantitative easing. On 22nd June the Bank signalled that the economy might be even weaker that it had previously believed.
- The National Institute of Economic and social Research estimates that GDP in the second quarter of 2011 will have grown a paltry 0.1%.

USA

Positive Influences

- GDP growth for the first quarter of 2011 was revised up to 1.9% from 1.8%. This compares with 3.1% growth in the previous quarter.
- On 22nd June the Federal Reserve Board (FED) held interest rates in the range 0 – 1/4%. Bernanke, the chairman of the FED said that rates would continue to be on hold for "an extended period".
- CPI for April was +1.5% p.a.
- On 30th June the FED officially ended its quantitative easing programme.
- The Institute of Supply Management's index of factory activity in June rose to 55.3 from 53.5 in May.

- Pending house sales surged by 13.4% in May whilst the National Association of Realtors index advanced by 8.2% against consensus estimates of 3.0%.

Negative Influences

- The Institute of Supply Management's non manufacturing index declined to 52.8 in April from 57.3 in March, a much larger dip than expected.
- The University of Michigan's consumer sentiment index for June dropped to 71.8 from 74.3 in May. The consensus estimate was 74.0.
- The Commerce Department stated that May retail sales fell 0.2% (April +0.3%). Car sales decreased by 2.9%, largely due to a disrupted supply of component parts from Japan.
- Durable goods orders for April decreased by 3.6% in marked contrast to the 4.4% rise in March.
- Consumer spending in the first quarter of 2011 was revised down to 2.2% from 2.7%.
- The FED seeks annual stress tests for banks and a procedure for reserving rights to veto dividend payments.
- The trade deficit in March grew by $2.8B to $48.2B due to surging oil prices. However, there was a healthy 4.6% rise in exports.
- On 5th May, the Labor Department stated that first time jobless claims rose by 43,000 to 474,000 compared with an estimate of 410,000.
- Non farm payrolls expanded by only 18,000 in June, well below of the consensus 100,000 estimate.
- The unemployment rate in June was 9.2% (May 9.1%).
- Retail sales increased by 7.2% p.a. in June.

Europe

Positive Influences

- The ECB has approved the appointment of Mario Draghi (current head of the Bank of Italy) to be the next President of the ECB, starting in October 2011.
- On 9th June the ECB held interest rates at 1 ¼%, but signalled a rise in July.
- The German government announced plans to close 8 of the country's 17 nuclear plants by the end of 2011. Currently nuclear power produces 23% of the nation's electricity. It is likely that there will be a move to natural gas.
- On 13th May GDP growth in the first quarter of 2011 for the following countries was:- Germany 1.5%, France 1.0%, Eurozone 0.8%. These rates were appreciably better than expected.
- On 28th June, Christine Lagarde, the French financial minister, was appointed the new managing director of the International Monetary Fund following the resignation of Dominique Strauss-Kahn.
- In Greece, George Papandreou's socialist party won the votes to approve the government's proposed tax increases and spending cuts totalling €28B.

Negative Influences

- The Greek government reform efforts under George Papandreou appear to have ground to a halt with a sovereign debt default looking increasingly inevitable. It is increasingly obvious that Greece will find it difficult to raise

much more than a quarter of the €50B proceeds needed from asset sales and privatisations. The European Commission estimates that the Greek economy will shrink by 3.75% in 2011 to be followed by only marginal growth in 2012. The Standard & Poors rating agency downgraded Greece's long term sovereign credit rating by three notches to triple C.

- On 23rd June the fears of debt contagion within the Eurozone sent the Euro to a record low against the Swiss Franc of 1.1853.
- Mr Trichet of the ECB warned that financial stability in the Eurozone was "flashing red" as the debt crisis threatened to further infect the regions' banks.
- The Bank of France cut its estimate of GDP growth in the second quarter of 2011 to 0.4% from 0.5%.
- Unsurprisingly, in Italy, Silvio Berlusconi's People of Liberty party has suffered in the local elections.
- On 31st May the level of unemployment was unchanged at 9.9%.
- The Eurozone's composite purchasing managers' index, covering both manufacturing and service sectors fell to 55.4 in May (April 57.8). The respective German index fell to 56.4 from 59.0.
- The Organisation for Economic and Co-operative Development (OECD) stated that "Italian gross domestic product will not return to its pre-crisis level before 2013-14".
- On 3rd May Portugal agreed a €78B financial rescue package with the European Union and the International Monetary Fund.
- Eurozone inflation was unchanged at 2.7% in June.
- On 30th June, Trichet of the ECB said it was "in a state of strong vigilance". In other words "banker speak" for a imminent rate rise.
- Whilst Turkey's GDP growth was a substantial 11.0% in the first quarter of 2011, the country's trade deficit stood at a record high of $10.1B in May, driven by strong consumer spending.
- The Eurozone's retail sales in May receded to 1.1% from 0.7% in April.

Japan

Positive Influences

- The Prime Minister, Naoto Kan, has said he will resign with no firm date given.
- Output rose by 1.0% in April.
- Industrial production in May rose sharply by 5.7% compared with the rise in April of 1.6%. This was the largest increase since March 1953 and reflects the recovery of the nation's supply chain in the aftermath of the severe disruption caused by the tsunami and earthquake.

Negative Influences

- Preliminary data suggest that GDP fell 0.9% in the first quarter of 2011. This is equivalent to an annualised rate of -3.7% (previous quarter -3.0%). In the light of these figures economists estimate that Japan is technically in recession.

Asia/Pacific

Positive Influences

- The Reserve Bank of India's data showed that foreign direct investment by Indian multi national corporations had expanded markedly to $43.9B in the 2010/2011 fiscal year from $18.0B in the previous year.
- In the first 4 months of 2011 China's foreign exchange reserves grew by approximately $200B with three quarters of this amount being invested in currencies other than the US dollar.
- In 2010 China overtook the USA as the world's largest consumer of energy. Of the global total of energy consumed China accounted for 20.3% versus the 19.0% for the USA.
- China has continued to forge trading ties with South American agriculture, energy and mineral providers.
- According to the World Gold Council, Chinese investors bought 93.5 tons of gold in the first quarter of 2011. This is a 55% increase from the previous quarter.

Negative Influences

- India's wholesale price inflation rose 9.1 % p.a. for May.
- Indian GDP growth for the first quarter of 2011 was 7.8%, the fifth consecutive month of slowing growth.
- Chinese inflation in June increased to a 3 year high of 6.4% driven by a 14% p.a. increase in food prices. The government's inflation target is 4.0% p.a.
- Australian GDP growth was a negative 1.2% in the first quarter of 2011 due to the floods and cyclone in the mining and agricultural regions of the country.

Conclusion

The provisos and factors that are likely to influence the course of asset classes between now and the year end are very similar to those highlighted in my previous report for the quarter ended 31st March 2011. They can be encapsulated as follows:-

- In the UK, the Coalition Government will need to keep firm control of the austerity measures which have been introduced to all levels of the economy, both for consumers and for corporations. It will be important for the government to cope with trade union discontent and possible strike action. The Bank of England seems likely to continue to play its part in the economic recovery by keeping interest rates on hold. Possibly for several months.

- In the USA, as already mentioned, it appears fiscally vital for President Obama to knock both Democratic and Republican heads together in order to at last enact a solution for reducing both the national deficit and also the deficits within underlying states, some of which are in a most parlous position close to default. As so often has been the case in the past, it will most likely be the strong earnings of the great American corporations that will improve the economy and in turn lift GDP growth and productivity.

- In the Eurozone, the most worrisome economic and financial conditions of the peripheral countries will continue to be a problem, especially in Greece whose successive governments over many years have been reckless with their debt ridden management of the economy. Small wonder that the rating agencies have been swift to downgrade the national debts of these countries. The precise timing of a solution to the peripheral problems within the Eurozone is hard to deduce.

However, on a less gloomy note, both Germany and France, the acknowledged mainstays of the Eurozone, have exhibited ongoing financial strength. There seems little doubt that, when the troubles are eventually resolved, the Eurozone countries will necessarily have to move to a two tier system in which the Euro currency will most certainly stay, but that there will have to be special provisions for the weakest economies. Hardly a conducive background, but one in which investment managers stock selections will become even more important. Certainly within the Eurozone equities still appear attractive, particularly those with good dividend yields.

- Within Japan, the nation is showing clear signs of recovery from the devastation caused by both the earthquake and the accompanying tsunami. However, full recovery will take time and will be hampered by a less than dynamic political leadership under Naoto Kan. In these troubled times for the economy recent stock selection has been biased towards the international companies in Japan.

- Within the Asia/Pacific region the greatest influence will continue to be the Chinese economy and the actions of its government and central bank. Certainly China will remain the catalyst for buoyant GDP growth within the respective regions, particularly as they benefit by exporting to China. However, the currency manoeuvring of the People's Bank of China will have to be carefully watched. In that regard more interest rises seem a distinct probability.

- In general investors will wish to be reassured that UK and global banking systems are becoming more trustworthy with greater transparency and adequate levels of capital backing.

Despite the geopolitical problems (particularly in the Western Hemisphere) grounds for optimism can still be found. For instance, world trade is still reasonably robust with an estimated rate of GDP growth in the 4% plus region. Additionally, world central bank interest rates are mostly extremely low in an historic perspective. Furthermore, there is evidence that investors both private and institutional have higher levels of cash than they would normally hold which may soon be recommitted to the equity markets due to the miniscule returns on liquidity. It is an amalgam of these factors that gives rise to mild optimism between now and the end of the year, particularly for equities which are still standing at relatively attractive levels. This should translate into returns in the low single digit area but positive none the less. If such optimism proves to be misplaced it will most likely be because GDP growth rates prove to be less than expected or because inflation rates are greater than estimated or because the economies of the UK and the USA slip back into recession.

With regard to other asset classes, traditional Fixed Interest returns as a whole are likely to be flat for the year. This is simply because interest rates in general are set to rise this year, although later rather than sooner in the UK and the USA. Also there is now little wriggle room in shorter maturities. However, enhanced Fixed Interest alternative products should show positive returns. Private Equity should continue to thrive on the high quality opportunities that are available due to a growing number of mergers and acquisitions, a vibrant IPO market together with a more liquid secondary market. Over the longer term Private Equity as an asset class seems likely to outperform equity returns as it has done for so many years in the past. Property should continue to benefit from attractively priced prime situations which are still available, particularly in the office sector both in the UK and globally. This asset class as a whole

should continue to make a consistent and soundly based recovery from the nadir valuation levels of 2008. Hedge Fund of Funds, after a distinctly soft period, should now be able to improve their returns against a conducive background of increased volatility and lessening correlation. It will be prudent for Hedge Fund of Funds to spread their risk over a sufficiently large spectrum of sub fund specialists lest they become too focussed. Whilst Emerging and Frontier equity and debt markets will still be perceived to be at the higher end of the Richter scale of risk, this asset class, with the benefit of more strongly growing rates of GDP versus the developed countries, should be able to demonstrate worthwhile returns, particularly in the Asia/Pacific region and parts of South America. Global Tactical Asset Allocation should continue to provide a useful added return for a pension fund portfolio despite the volatile reputations of this asset class. Part of this volatility is usually caused by GTAA's participation in the foreign exchange markets. Within Infrastructure opportunities abound with many countries across the world introducing infrastructure programmes, not the least of which is the USA with a substantial spend on public highways and bridges. The same applies within China and India. The principle benefit of investing in Infrastructure remains the virtually guaranteed real return providing an ideal protection against inflation. Commodities have continued to be volatile and more recently have been buoyed by the expectation that the industrialised nations' economies will make a worthwhile recovery in the second half of 2011. As always, the progress of the Commodities sector will be volatile. By its very nature Foreign Exchange will also prove to be volatile, but this is scarcely surprising with such a high percentage of global turnover attributable to speculation. However, nimble and well informed managers should still be able to achieve a worthwhile return over time. Their performance should be measured over a longer period of time and investors should not be phased by quarters in which performance is well below the benchmark.

Valentine Furniss
12th July 2011

Investment Update for the Month of July 2011

The index returns and exchange rate movements for the month of July are shown in the tables below:-

	Indices	**Month ended 31/07/11**
		%
Equities		
Japan	FTSE Developed Japan	1.3
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	-1.7
UK	FTSE All Share	-2.2
Emerging Markets	MSCI Emerging Markets Free	-2.6
North America	FTSE North America	-4.2
Europe	FTSE Developed Europe (ex UK)	-7.3
Fixed Interest		
UK ILGs	FTSE British Gov. Index Linked Over 5 years	3.8
UK Gilts	FTSE British Government All Stocks	3.2
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	2.6
Property	IPD*	N/a
Cash	Merrill Lynch LIBOR 3 Month	0.1

* The IPD UK Property return in May 2011 was 0.7% (the returns for June and July 2011 are not yet available)

Currency movements for month ended 31st July 2011

Currency	30th June 2011	31st July 2011	Change %
USD/GBP	1.606	1.642	+2.3
EUR/GBP	1.107	1.142	+3.2
USD/EUR	1.449	1.437	-0.8
YEN/USD	80.760	77.190	-4.4

During the month there continued to be a manic investor focus on two prime areas of concern. First and foremost on the course of negotiations at the White House regarding the US deficit. And, secondly, on the likelihood that one or more peripheral Eurozone countries would default with implications for the Euro. Indeed, equity and fixed interest markets waxed and waned in tandem with the constantly changing perception of these two prime market influences. As can clearly be seen from the table above, the fixed interest sectors markedly outperformed equities both within the UK and globally. Only Japanese equities were positive with a marginal gain of 1.3% on the assumption that the country was recovering well from the disruption caused by the devastating tsunami and earthquake earlier in the year. In the light of the aforementioned investor fears concerning the Eurozone and US problems it is scarcely surprising that these equity markets were markedly the worst performers in returning -7.3% and -.4.2% respectively. Next worst was the return on Emerging Markets -2.6% with a tendency for investors to lose their nerve, albeit temporarily for areas of greater risk. In the UK, there was sufficient apprehension and “not out of the woods” thinking to cause a negative return of 2.2%. The Asia Pacific return was -1.7% as the markets became worried about the possibility of weakening economic growth in China. Within the fixed interest sectors the front runner was Index Linked Gilts returning a surprisingly strong +3.8% possibly exaggerating the expected inflation increase in the UK. Gilts as a whole returned a robust 3.2% return: quite an achievement with their yields driven so low by safe haven investors seeking sanctuary in troubled and confusing times. Corporate Bonds returned a healthy +2.6% caused no doubt by their relatively attractive yields.

The factors of a general nature to influence the course of stock markets during the month were as follows:-

- Foreign exchange markets were extremely volatile against most unstable financial and political backgrounds. Fearful investors sort sanctuary in the perceived safe havens of the Yen and Swiss franc. The volumes of foreign exchange transactions were so substantial that both the Japanese and Swiss central banks took defensive action attempting to weaken their currencies lest it affect their export trade. German bunds were also seen as a safe haven.
- Investors also sort security against market turbulence with heavy purchases of gold causing the price of the metal to soar to a record high of $1,632.30 per Troy ounce on 29th July.
- Within the UK and globally, whilst corporate earnings and dividends have generally been better than expected, chairmen’s statements have mostly warned about the deteriorating state of respective economies which could lead to lower rates of national GDP.
- There has been increasing criticism by corporations, consumers and investors alike that the governments of struggling economies have been far to slow to address their financial problems. That has been especially the case in the USA and the Eurozone. In the latter case essential cohesion is difficult to achieve amongst 17 member countries.

- Banks in most areas have remained tight-fisted with unsatisfactory levels of lending in the struggle to improve their individual liquidity ratios and hence their tier status.

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

UK

- Petrol prices rose to 136.40 pence per litre.
- The Office for National Statistics reported that GDP growth in the second quarter of 2011 was a feeble 0.2%.
- Vince Cable, of the Coalition government urged the Bank of England to consider ending its programme of quantitative easing.
- Retail sales volume (ex fuel) rose a somewhat surprising 0.8% in June (May - 1.6%) which was better than forecast.
- The News of the World was closed down amid the phone hacking debacle.
- In the three months to May unemployment fell by 26,000 to 2.45M. Much of the fall was attributed to the increasing number of young people going into full time education rather than work.
- Consumer price inflation for June was 4.2% down from 4.5% in May.This was better than the consensus estimate for no change.
- The British Retail consortium reported June sales up 1.5% p.a. versus May's - 0.3% p.a.

North America

- The ISM manufacturing index for July sank to 50.9 (June 55.3) which was far worse than expected.
- The Bureau of Economic Analysis said that the economy only grew at 1.3% in the second quarter of 2011 and it also revised its quarter one estimate to 0.4% from 1.9%.
- The Bank of Canada unexpectedly signalled an interest rate rise in the "next few months". The Bank also decreased its GDP growth estimate from 2.9% to 2.8% for 2011 and expects lower growth of 2.6% in 2012.

Europe

- Mr Zapatero, Spain's socialist prime minister, is to call an early election on 20th November, He appears to have lost credibility in combating the country's weakening economic state. In a similar vein, the embattled Silvio Berlusconi of Italy is also under rising pressure to resign. His centre right party does not appear to be able to create a sufficiently rigorous enough austerity programme that Italy so urgently needs.
- On 27th July, Moodys, the rating agency, downgraded Cyprus's sovereign debt on increasing fears that the country will have to be bailed out. Not at all surprising due to Cyprus's Greek connection.
- The Eurozone agreed a further bail out of Greece worth €159B; thus acknowledging that Greece's first reserve package was totally inedaquate.
- On 15th July the result of the European Banking Authority's stress tests showed that only 8 of the 90 banks tested had in fact failed the test.

- On 5th July the rating agency Moody's downgraded Portugal's sovereign debt. Also on 5th July Sweden's central bank, the Riksbank, raised its interest rate by ¼% to 2% representing the seventh rise in the past year. The Bank is forecasting GDP growth of 4.4% for 2011 against its previous estimate of 4.6%. GDP growth in 2010 was 5.7%.
- On 7th July, as expected, the European Central Bank raised interest rates by ¼%.

Japan

- There were no important events or macro economic data recorded in July. Over the years it has become apparent that the Japanese modus operandi and old fashioned culture is essentially low key. This is unhelpful when evidence is needed that the economy is not going to slip back into the deflationary mire that has enveloped the nation for so long.

Asia/Pacific

- On 22nd July the Reserve Bank of India increased interest rates by ½% to 8.0%, its eleventh increase in 18 months specifically designed to combat inflation.
- In the second quarter of 2011 China's foreign exchange reserves grew by $153B to $3,179B.
- China's CPI for June was an uncomfortably high 6.4%.
- China's rate of GDP growth in the second quarter of 2011 was 9.5%, higher than expected. For the year to 30th June industrial production rose a substantial 15.1%.
- On 6th July China's central bank raised interest rates for the fifth time in 8 months with the principle aim of damping down inflation. As a result the benchmark one year lending rate increased by ¼% to 6.56% and the one year deposit rate to 3.5%.

Conclusion

So what has occurred in the month of July to affect the concluding opinion on equity markets contained in the investment report for the quarter ended 30th June in which a position of mild optimism was recommended. The answer is that there has, throughout the month, been a marked deterioration in investor confidence triggered by the problems in the US and the Eurozone proving much more intractable and serious than most market strategists, economists, forecasters and central banks had envisaged. Areas of greatest concern have included the fear that the level of world trade is proving to be below most forecasts. Furthermore, inflation has also proved to be a greater threat than thought. So, taken as a whole, it seems prudent to adopt a more cautious investment stance and to suggest that most equity markets are likely to be flat for 2011 as a whole. Such an outcome would be a clear disappointment and confound forecasts made earlier in the year. With regard to Fixed Interest markets, yields on both UK gilt edged and US Treasury stocks have now become so low (as they are seen as the ultimate safe haven) that, from here to year end their returns also seem likely to be distinctly flat. A policy of "caveat emptor" seems warranted against this difficult and increasingly worrying background.

Valentine Furniss

Addendum covering the week ended Friday 5th August

The tumultuous events during the above week and accompanying global market collapse most certainly warrant an addendum briefly to explain what has happened and why it has happened.

Market Movements for the Week ended Friday 5th August

	July 29	Aug 5	Wk's Change%
S &P 500	1292.28	1199.38	-7.19
Nasdaq Comp	2756.38	2532.41	-8.13
Dow Jones Ind	12143.24	11444.61	-5.75
FTSE/Eurofirst 500	1082.12	975.02	-9.90
Euro Stoxx 50	2670.37	2375.15	-11.06
FTSE 100	5815.19	5246.99	-9.77
FTSE All-Share UK	3026.02	2727.18	-9.88
CAC 40	3672.77	3278.56	-10.73
Xetra Dax	7158.77	6236.16	-12.89
Nikkei	9833.03	9299.88	-5.42
Hang Seng	22440.25	20946.14	-6.66
FTSE All World $	221.19	202.24	-9.57
Oil Brent	$116.74	$109.37	-6.31
Gold	$1,616.85	$1,648.40	+1.91

The principal cause of the above precipitous falls was the sheer frustration of both investors and citizens that their respective governments and central banks had been unable to act with sufficient speed and cohesion to take the essential decisions so urgently needed in order to rectify fiscal deficits, weakening economic growth and increasing inflation. These negatives became like ticking time bombs in the minds of investors who were becoming daily more fearful. Therefore something had to give and on 1st August it did with stock markets collapsing both in the UK and around the world with no market being left unscathed. The magnitude of the ensuing losses is shown in the tables above for the week ended Friday 5th August. Apart from the size of these losses, what has concerned shareholders most is not only the depth of the losses, but the sheer speed at which they were incurred. In that regard modern equity transactions can take place within seconds with trades often being automatically triggered by computer driven selling programmes causing a downward spiral. The use of an increased number of protective derivatives has also added to the selling process. In a word, this truly awful performance over such a short period of time should be seen as a capitulation of investors' confidence as they were confronted by a wall of so much worry and concern. The final straw was the stigma caused by the downgrading by Standard & Poors' of American sovereign debt from AAA to AA+.

It does seem obvious that before any meaningful recovery can take place and a degree of calm restored the following principal areas of investor and country concerns will have to be addressed.

- Better leadership in the USA to help solve the current fiscal deficit with less counter productive political squabbling and brinksmanship.
- That the 17 Eurozone countries will have to address the economic and financial problems of the peripheral members, especially Spain and Italy. Until this is achieved the status of the Euro and its very survival will continue to be questioned.
- Assurance regarding world economic growth and trade.

- That the multitude of current global problems will not result in a return to double dip recessions, particularly in the UK and the USA.
- Better coordination across the globe of governments and central banks.
- That central bankers can contain inflation rates without affecting their respective economic growth rates.

For the above remedial measures to succeed will take time, but it does seem that respective governments will address them with much greater urgency than hereforto. Governments will also have to be much better supported by central banks, the IMF and Group of Seven etc. How much time will this restorative process take? Right now it is extremely difficult to gauge. But until background conditions are seen to improve, investors both private and institutional are likely to remain on the sidelines until their battered confidence returns. But history shows that confidence surely will return as investors become increasingly unhappy with the exceedingly low returns available on cash. When the turning point does come the area of greatest relative attraction to investors will be high yielding blue chip equities with the ability to pay consistently rising real dividends.

In sum, “caveat emptor” and beware of false dawns.

Valentine Furniss
9th August 2011