	Pension Fund Sub Committee 28th June 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 31st March 2011**

1. SUMMARY

This report provides a summary of fund activity during the quarter ended 31st March 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) Equity markets rose marginally during the quarter. Bond markets fell, on concerns about inflation and strengthening economic growth. Other markets also rose, but less rapidly.

b) The Fund has risen in value from £476m to £486m, and has outperformed its benchmark over the quarter (+0.3%) as a result of stock selection (outperformance in bonds, infrastructure, GTAA and private equity). The Fund outperformed the average local authority fund (+0.3%), mainly as a result of good returns in infrastructure and GTAA. Over one year, the Fund has equalled its benchmark (+2.1%). Over one year, the Fund has underperformed the average fund (-1.5%) as a result of lower exposure to equities / higher exposure to alternative assets and poor performance in global equities, hedge funds and private equity, offset by good performance in GTAA, infrastructure and UK small companies.

2. RECOMMENDATIONS

Members are asked to note this report.

3 DETAIL

ECONOMIC AND MARKET BACKGROUND - QUARTER ENDED 31ST MARCH 2011

3.1 Equity markets rose marginally during the quarter, despite the market volatility occasioned by the earthquake and tsunami in Japan. The UK and Asian markets hardly changed, Europe rose by 1%, USA 4%, and Japan fell by 5%. 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.Rates may rise to head off inflationary expectations, but the timing is uncertain. Markets expect rates to rise to around 2% by the end of 2013.

- Headline inflation (RPI) rose by 5.2% in the year to May (4.7% January), and the Index of Consumer Prices (CPI) rose by 4.5% (4% January). It is expected that inflation will rise in the short term, 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 2.3% p.a. in March (1.1% December), below the Bank of England's 'danger level' (4.5%). Unemployment (claimant numbers) has fallen to 1.47m, but may rise as public expenditure is reduced and taxes raised following the recent budget.
- The UK economy shrunk by 0.5% in Q4 2010 (growing by 1.4% in 2010), following disruption from poor weather and a slowdown in growth. GDP rose by 0.5% in Q1 2011 (1.8% year on year), and is expected to grow by 1.5% in full year 2011.
- It has been anticipated that consumer spending will fall, though retail sales were up 2.8% in the year to April. The squeeze on incomes and the rising pricve of commodities may depress demand. House prices have fallen by 4.2% over one year to May (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 following tax cuts and quantitative easing (QE) programmes. Improved payroll data, strong retail sales and a rebound in home construction have indicated that a recovery is underway, but house prices continue to fall. It is anticipated that company earnings will improve. However, the impact of the Japanese earthquake on world supply lines is expected to be negative. It is expected that Eurozone GDP will grow by 1.5% in 2011, supported by strong growth in Germany, but an increase in rates by the ECB may hit peripheral markets hard. Growth in China and India is forecast to be around 10% in 2011 – emerging market growth is strong and providing export growth to developed economies. 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 31st March 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 31.03.11 % (5)	Market Value 31.12.10 £M (6)	Market Value 31.12.10 % (7)	WM LA Average 31.12.10 % (8)
Fixed Interest							
UK Gilts	15.6	3.2	10.3	4.5	17.5	3.7	9.5
Corp.Bonds	24.0	4.9	*	4.5	23.8	5.0	*
IL Gilts	1.7	0.3	4.6	-	-	-	4.7
Overseas	0.0	0.0	2.6	-	-	-	2.2
Emerg. Market	8.3	1.7	-	2.0	8.4	1.8	-
Infrastructure	0.9	0.2	-	-	0.9	0.2	-
Secured loans	4.6	0.9	-	2.0	4.4	0.9	0.7
Credit Opps.	9.2	1.9	-	2.5	12.1	2.5	*
Credit Alpha	12.5	2.6	-	2.5	12.3	2.6	*
Currency Fund	0.6	0.1	-	-	0.6	0.1	
Equities							
UK FTSE350	72.8	15.0	31.1	12.5	72.3	15.2	30.9
UK Small	15.8	3.3	*	4.0	15.9	3.3	*
O/seas - developed	122.5	25.2	35.6	22.5	116.4	24.5	34.4
O/seas – emerging	36.6	7.5	*	8.0	37.1	7.8	*
Other							
Property – UK	26.6	5.6	6.3	8.0	25.2	5.3	6.0
Property – Eu.	6.9	1.4	*	*	6.6	1.4	*
Hedge funds	42.3	8.7	1.5	10.0	42.0	8.9	2.4
Private Equity	49.1	10.1	3.1	10.0	47.8	10.1	3.0
GTAA	18.8	3.9	1.0	4.0	16.5	3.5	1.7
Infrastructure	8.1	1.7	*	2.0	5.3	1.1	*
Cash	9.0	1.9	3.7	1.0	11.0	2.1	3.6
Total	**485.9**	**100.0**	**100.0**	**100.0**	**476.1**	**100.0**	**100.0**

3.5 The main changes to the Brent Fund have occurred as a result of market movements, increased exposure to private equity (£0.8m), property (£1m), GTAA (£2m) and infrastructure (£1.9m). Since the end of the quarter there has also been further investment in UK property (£0.3m), UK Small companies, infrastructure and private equity.

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 31st March 2011.

Table 2: Investment Returns in Individual Markets

Investment Category	RETURNS						Benchmark/ Index Description
	Quarter Ending 31.03.11			Year Ended 31.03.11			
	Fund %	Benchmark %	WM Local Auth %	Fund %	Benchmark %	WM Local Auth %	
Equities			1.4			9.2	
UK FTSE350 Equities	0.5	1.1	1.0	9.4	8.6	9.7	FTSE 350
UK Small Caps	-0.2	0.3		19.4	15.2		FTSE Smallcap ex IT
Overseas - developed	3.5	3.5	1.6	4.0	-	8.9	FTSE World 75% Hedge
Overseas - emerging	-1.2	-1.2	-0.7	-	-	-	FTSE AW - All emerging
Fixed Interest							
Total Bonds	1.0	0.5	0.4	5.2	4.5	5.7	Brent benchmark
UK Bonds	-0.5	-0.8	0.8	6.0	5.1	6.0	FTSE UK over 15 years
Index Linked UK	-	-	0.1	-	-	6.6	-
Corp Bonds	1.0	0.9	-	5.4	5.2	-	iBoxx Sterling Non-gilt
Secured Loans	4.1	0.9	-	10.6	3.7	-	3 month LIBOR +3%
Credit Opportunities fund	2.0	1.4	-	5.8	5.7	-	3 month LIBOR+5%
Other							
UK Property FOF	2.0	2.3	2.0	12.5	10.7	9.2	IPD Pooled index
Eu Property FOF	6.2	1.9	-	4.5	8.0	-	IPD All properties
Hedge Funds	0.7	1.2	1.4	1.0	4.6	5.7	3 month LIBID+4%
Private equity	1.7	0.1	4.5	5.8	0.4	10.3	LIBID 7 Day
Infrastructure	12.5	3.6	-	13.1	10.6	-	3 Month LIBID +4%
GTAA	2.0	1.1	-	27.2	7.4	-	FTSE 100
Cash	0.9	0.1	0.0	2.1	0.4	2.1	GPB 7 DAY LIBID
Total	**1.6**	**1.3**	**1.3**	**6.7**	**6.7**	**8.2**	

3.7 Returns for the quarter outperformed the benchmark by 0.3%, following outperformance in bonds, infrastructure and private equity. The main stock selection factors were:-

a) Fixed interest. Both the core and satellite portfolios outperformed their investment target. In particular, the satellite fund rose in value as secured loans and the credit opportunities funds added value.

b) Infrastructure. Capital values rose as management activities in such areas as shale gas and ports added value.

c) GTAA. The manager outperformed in January and February, but lost most of their gains as markets reversed following the Japanese earthquake. All four strategies lost value in March as the yen rose, stock markets fell, and bonds rose on flight to safety moves. However, all four strategies added value for the quarter as a whole. In particular, the bond market allocation added value through overweighting US and Australian bonds.

d) Property. In the UK, there have been new entrants to the Fund, allowing the manager to purchase assets at a discount. The manager expects the market to fall slightly this year, and is positioning the fund to avoid lower quality assets. 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 to commit cash.

e) Hedge funds. In benign markets, the manager added value from equity hedged, long bias macro managers, event driven, and multiple strategies. Short bias managers continued to underperform. Fauchier have been active in removing managers that are suffering style drift or have become over cautious, and has increased exposure to event driven and specialist credit managers.

3.8 Over one year, the Fund equalled the benchmark. Asset allocation lost value through overweights in UK equities and underweights in UK Small companies. Stock selection added value – UK equities, UK Small Cap, bonds, GTAA and private equity outperformed the benchmark, while overseas equities and hedge funds underperformed.

3.9 The Brent fund has outperfomed the WM Local Authority average for the quarter (0.3%) as a result of good returns from credit (the fixed interest satellite portfolio), overseas property, infrastructure and GTAA.

3.10 The Brent fund has underperformed the average local authority fund by 1.5% 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 small companies, infrastructure and GTAA, partially offset by underperformance in overseas equities, hedge funds and private equity.

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 April and May included buying and selling stocks to improve tracking error and to invest dividends.

NEW DEVELOPMENTS AND FUTURE INVESTMENT OUTLOOK FOR THE BRENT FUND

3.13 Markets have been steady during April and May. The property manager expects UK property market growth to be very low in 2011.

3.14 Henderson Global Investors has completed the takeover of Gartmore Asset Management. The Gartmore small company team will remain as a discrete unit within Henderson. It is intended that exposure will be increased back to benchmark over a period.

3.15 Fauchier Partners advised that the opportunities in distressed debt are less than expected, so it is not worth Brent joining a new fund. However, the manager has expanded exposure to distressed debt within the Jubilee Fund, so Brent will still get access to opportunities that appear.

3.16 The transfer of emerging market equity investment from LGIM to Dimensional Fund Advisers is expected to occur early in July.

3.17 As part of the quarterly meetings that officers and the Independent Adviser hold with managers, we have discussed asset allocation issues with Henderson Global Investors and Capital Dynamics. Henderson has advised that the actions previously taken by the sub committee to establish core and satellite portfolios remains appropriate. Capital Dynamics has confirmed that Brent's exposure to private equity is likely to rise above the 10% target, mainly because the Brent Fund has not grown as much as was hoped and because disposals have been slow, but that investment in future funds will be scaled back to reduce the excess.

3.18 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 – March 2011 quarter report
Legal & General – March 2011 quarter report
Fauchier Partners – March 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

Report from the Independent Adviser

Investment Report for the Quarter ended 31st March 2011

Market Commentary

Seldom, in any quarter, have so many adverse factors and events coincided to affect the global markets for almost all asset classes.

The obvious and much reported adverse factors were as follows:-

- The devastating earthquake and tsunami in the Sendai region of Japan which caused so much human suffering and homelessness, and the disruption both to the economy and to supply chains of vital goods and services.
- The people power rebellions in Tunisia and Egypt, which were followed by similar confrontations in other North African and Middle Eastern countries. The most serious rebellion appears to be against the Gaddafi regime in Libya with the possibility that the country could become a failed state and be riven by civil war. Like it or not, one of the most worrisome concerns about the uprisings is the future ownership of important oil fields and possible disruption of their supply systems. As a result the rising price of crude oil would have implications for global inflation rates.
- Bank stress tests served to highlight the continuance of large deficits in the peripheral Eurozone countries, particularly Greece, Ireland and Portugal and triggered fears that the contagion effect might permeate Spain.
- In most areas of the world inflation was on the rise caused by the soaring prices of energy, food and commodities both soft and hard.The consequence of this has been further hardship for household incomes both in the UK and globally.

The index returns and currency movements both for the quarter and year ended 31st March 2011 are shown in the tables below.

Index returns expressed in sterling

		Q/e 31 March 2011
		%
Equities		
Europe	FTSE Developed Europe (ex UK)	5.4
North America	FTSE North America	3.4
UK	FTSE All Share	1.7
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	0.6
Emerging Markets	MSCI Emerging Markets Free	-1.4
Japan	FTSE Developed Japan	-7.6
Fixed Interest		
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	1.0
UK Gilts	FTSE British Government All Stocks	0.8
UK Index Linked Gilts	FTSE British Government IL Over 5 years	-0.4
***Property**	IPD	Not available
Cash	Merrill Lynch LIBOR 3 Month	0.2

* The IPD index returned 1.4% over January and February.

Currency Movements for quarter ended 31st March 2011

Currency	31st December 2010	31st March 2011	Change %
USD/GBP	1.566	1.603	+2.4
EUR/GBP	1.167	1.130	-3.2
USD/EUR	1.342	1.419	+5.8
YEN/USD	81.105	82.880	+2.2

Considering the barrage of bad news, the quarterly index returns shown in the table above were remarkably resilient. All the more so in the light of the obviously weak returns earlier in the reported quarter, particularly in the month of January.

The back marker in the quarterly returns was Japan (-7.6%) which was understandably very badly affected by the earthquake and tsunami. Although emerging market equities returned a negative 1.4% this was a strong recovery from January's return of (-4.9%). Top place on the equity leader board was Europe up a robust 5.4%. This should be seen as distinctly surprising in view of the continuing acute financial problems of Greece, Ireland and Portugal and the parlous state of their economies. It was caused in part by investors buying quality high yield equities which had become patently over sold. The engine of European growth, namely the German economy, has continued to power along. North America (+3.4%) was also a credible performance as it appears, from a global perspective, to have been seen as a relatively safe haven. The UK was above water (+1.7%) despite the severe austerity measures of the coalition government. The Asia/Pacific region turned in a muted (+0.6%) return because of fears of heightened inflation in China together with its interest rate rises and the effect that lower Chinese demand might have within the Asia/Pacific region as a whole.

Fixed Interest returns managed to end the quarter in modest plus territory with the exception of index linked (-0.4%). Property continued its recovery at a consistently modest, but consistent, pace with the IPD UK property return 1.4% higher over January and February.

UK

Positive Influences

- The purchasing managers' index for March increased to 57.1 from 52.6 in February, much higher than forecast.
- The Office for National Statistics (ONS) reported that the services sector output grew by 1.3% in January (December -1.1%).
- The Budget on 22nd March held few surprises and was generally taxation neutral. However, corporation tax is to be cut by 2.0% to 26% from April.
- The British Retail Consortium reported that in February total sales advanced 1.1% p.a., but much of this rise was due to the rise in VAT.

Negative Influences

- The Statoil company of Norway put on hold 2 oil and gas projects in UK waters worth £6.25B because of the British government's increased tax on oil production.
- The current account deficit increased to £10.5B in the fourth quarter of 2010 compared with the £8.7B deficit in the previous quarter.
- The Budget contained the following more realistic Government estimates:-

    - 2011 GDP cut from 2.1% to 1.7% (2012 GDP from 2.6% to 2.5%)
    - 2011 inflation raised from 3% to 4.5% (2012 inflation from 1.9% to 2.5%).
- The Organisation for Economic Co-operation and Development (OECD) cut its economic growth estimate for 2011 from 1.7% to 1.5%.
- CPI inflation in February increased to 4.4% p.a. against 4.0% p.a. for January. This compares with the Bank of England's target of 2.0%.
- The ONS reported February retail sales volumes slipping by 0.8%.
- On 16th March the ONS stated that unemployment at 2.53M people reached a 17 year high, representing an unemployment rate of 8.0%.
- The ONS revised its fourth quarter 2010 GDP growth rate to -0.6% from -0.5% due to poor weather.
- On 9th February, the ONS announced the largest deficit in trade in goods in history. The net deficit widened to £9.2B in December (November £8.5B).
- The British Retail Consortium's monthly survey for March showed that sales fell by 1.9% p.a., the worst drop since 1995.

USA

Positive Influences

- Payrolls rose by 216,000 in March and unemployment eased to 8.8% form 8.9% in February.
- Consumer spending, which accounts for approximately 70% of the US economy, rose 0.7% in February according to the Bureaux of Economic Analysis. This compared with January's rise of 0.3%.
- The Commerce Department stated that GDP for the fourth quarter of 2010 rose 3.1% versus an earlier estimate of 2.8%.
- The Philadelphia Federal Reserve Board's business activity index experienced its best monthly reading since 1984 for March of 43.4, higher than the 36.1 in February and also the consensus estimate of 28.8.
- On 15th March the Federal Reserve Board held interest rates in the range 0 – ¼%.
- Oil output in 2010 was at its highest level since 2002.
- The Institute of Supply Management's (ISM) index of manufacturing activity increased to 61.4 in February, up from 60.8 in January.
- Surprisingly, the National Association of Realtors stated that home resales in January increased by 2.1% compared with a consensus estimate for a decline of 5.3%.
- With regard to jobs, on 9th February Bernanke stated "a notable decline in the unemployment rate in December and January together with an improvement indicated in job openings and firmer hiring plans do provide some ground for optimism on the employment front".

Negative Influences

- The ISM's non manufacturing index retreated to 57.7 in March from February's 59.7.
- The Department of Agriculture announced that farm commodities, such as corn and soybeans rose sharply. This was caused by the Government stating that national inventories were much lower than expected which evoked a degree of

panic buying. The Department added that food inflation would surge in the second half of 2011.

- The Commerce Department reported that orders for manufactured goods fell by 0.1% in February compared with the rise of 3.3% in January.
- Home prices in March fell for the seventh consecutive month.
- The consumer sentiment index dropped to 67.5 in March, down from 77.5 in February.
- New home sales collapsed by 16.9% p.a. in February and new home construction fell by 20.8% p.a., the biggest drop since 1984 and compared with the January rise of 14.6%.
- A fifth of the US population now qualifies for food stamps, the highest level in the 50 year history of the programme.
- The University of Michigan's index of consumer confidence showed a large fall to 68.2 in March from 77.5 in February.
- The index of consumer confidence in March decreased to 63.4 from February's 72.0 which was a three year high.
- In Bernanke's six monthly monetary policy report to Congress he said "sustained rises in the price of oil and other commodities would represent a threat both to economic growth and overall price stability, particularly if they were to cause inflation expectations to become less well anchored".
- Retail sales in January increased 0.3% versus an estimate for a rise of 0.6% and December's figure of +0.5%. This was partly blamed on adverse weather.

Europe

Positive Influences

- Sweden's economy grew by a record 7.3% in the fourth quarter of 2010 representing Europe's strongest rate of economic growth.
- In Ireland's election the Fine Gail party convincingly beat Fianna Fail.
- Germany's February exports grew by a much better than expected 2.7%.

Negative Influences

- Eurozone consumer prices rose to 2.6% p.a. in March from 2.4% p.a. in February. The European Commission estimates that Eurozone inflation will average 2.2% in 2011.
- Eurostat reported that Eurozone GDP advanced a meagre 0.3% in the fourth quarter of 2010 which was unchanged from the previous quarter.
- German industrial orders for February increased by 2.45 (January +3.1%).
- Germany's IFO business confidence index slipped to 111.1 in March from 111.3 in February.
- German inflation grew by 2.2% p.a. in February (January +2.0% p.a.).
- Nicolas Sarkozy's UMP party lost popularity in France's Local Elections.
- After further stress tests four leading trust banks admitted that they needed a further incredulous €24B, pushing the total cost of their rescue to €62B.
- The resignation of the Portuguese Prime Minister, Jose Socrates of the Socialist Party, adds to the political chaos in the country and further increases the likelihood that Portugal will have to resort to the European Financial Stability Facility for a bail out package.

- On 16th March Portugal's debt was further down graded by both the rating agencies Moodys and also Standard & Poors. On 10th March Spain's credit rating was down graded by Moodys to AA2.
- On 3rd March the European Central Bank held interest rates at 1.0%, but signalled that rates could rise in April.

<u>Japan</u>

<u>Positive Influences</u>

- In a statement, the minister for economic and fiscal policy attempted to play down the economic damage to Japan stating that the most affected areas only accounted for some 4.0% of the nation's GDP. He added that the necessary substantial spending on reconstruction would be beneficial to the economy.

<u>Negative Influences</u>

- It goes without saying that the news that transcended all other events was the tragic earthquake on 11th March which triggered the devastating tsunami which so damaged the six nuclear reactors at the Fukushima Daiichi power plant and threatened a nuclear meltdown, thus markedly reducing the nation's electricity supply. The Nikkei index lost a sixth in 2 days with the shares of Tokyo Electric Power Company, the plant's operating company, collapsing by 23.5%.
- Apart from the humanitarian crisis and its accompanying homelessness many of the affected areas of Japan suffered from acute dislocation. A direct consequence of this was disruption in the supply chain both amongst Japanese corporations and those global manufacturers that were reliant on the import of components and spare parts from Japan i.e. international motor companies and also technology companies. Global luxury goods exporters to Japan are also suffering as are insurance and re-insurance companies. Understandably, there are substantial fears for contamination of both domestic and sea water and also certain foods especially vegetables and fish.
- Although the economy grew by 3.9% in 2010, the rate of GDP in the fourth quarter of the year shrank by 0.3%. If economic growth continues to slow, Japan's debt to GDP ratio will become even more extreme.
- The purchasing managers' index for March sank to 46.4 from 52.9 in February. This was a two year low.
- Public support for the prime minister Neoto Kan and his administration hit a fresh low.

<u>Asia/Pacific</u>

<u>Positive Influences</u>

- India's purchasing managers' index for March was unchanged.
- On 10th March the Reserve Bank of New Zealand cut interest rates by ½% to 2 ½% stating that the move was aimed at "pre-emptively reducing the economic impact of the recent earthquake".
- China announced that it intends to build 45 airports over the next 5 years increasing the total number to 220.
- China's March exports grew by a prodigious 35.8%.

- China’s purchasing managers’ index for March rose to 53.4 from 52.2 in February.
- Allegedly China displaced Japan in 2010 as the world’s second largest economy.
- The Chinese Development Bank is in talks to build an alternative transport system to the Panama Canal that would link the Columbian Atlantic and Pacific coasts by a 220km railway.
- On 8th February, the People’s Bank of China, in order to tackle inflation, raised its one year deposit rate by ¼% to 3.0% and its one year loan rate by ¼% to 6.0%, representing the third rise since mid October 2010.

Negative Influences

- China announced it had suspended approval for new nuclear power plants.
- China’s trade balance for February changed from a surplus to a deficit of $7.3B due in part to the high cost of imported commodities.
- China’s rate of CPI inflation rose to 4.9% p.a. in January from 4.6% p.a. in December.
- On 10th March, the Bank of Korea raised interest rates by ¼% to 3.0% in order to pre-empt rising rates of inflation.

Conclusion

The principal regional influences that will likely drive the direction of stock markets in 2011 are as follows:-

In the UK

- There is no doubt that the continuing austerity measures imposed upon the British population are proving a severe test of the coalition government’s metal as it strives to decrease the appalling indebtedness of the nation. History suggests that newly elected governments suffer unpopularity in their early years with poor results likely in Local Elections.

In the USA

- President Obama will need, as a matter of urgency, to knock Democratic and Republican heads together to break the impasse over state finances and avoid a government shutdown. The Tea Party’s political momentum appears to be less of a force which could ultimately improve Obama’s chances of achieving a second term in office. Indeed, a compromise with the Republican party might well work in his favour. From an investment perspective, there are clear signs in the market place that, against a background of such global tumult, the USA is seen as a sanctuary.

In Europe

- In the short term much will depend on the efforts and collusion of the ECB and Germany as they strive to buttress the lower tier Eurozone members and hold the Eurozone together. It will be imperative that the contagion does not spread from Greece, Ireland and Portugal to Spain due to the size and relevant importance of that economy. Despite the current doomsayers and the effects of speculation, it does appear that Spain will be able to remain solvent.

In Japan

- It may very well prove that the determination, resilience and technological skills of the Japanese population will help them to recover. It may also be that the massive building and construction spending programmes will be a stimulus to the economy and provide the shot of adrenalin needed to resuscitate it and also the political dynamism so sadly lacking in the past administrations with their seeming lack of ability to extract the nation from the deflationary mire of some 10 years.

In Asia/Pacific

- The actions of China will of course continue to dominate the region and its massive imports will be a boost to its neighbouring nations. It seems likely that the Peoples' Bank of China will continue with its programme of raising interest rates in an attempt to curb inflation. The Bank is also showing signs of becoming more transparent.

The alternative asset classes of GTAA, Foreign Exchange, Hedge Fund of Funds and Commodities (particularly gold) should all benefit from the current volatility and lack of correlation in the market place together with an improvement in overall liquidity. Although these asset classes should be able to take advantage of current attractive opportunities and, in the longer term reduce portfolio risk, the shorter term caveat must be that performance will be erratic and subject, in certain cases, to market speculation (especially in foreign exchange). Property, private equity and infrastructure should also continue to make worthwhile progress and, most importantly, to produce a consistently rising real return. At this time each of these three asset classes have an abundance of attractive opportunities from which to take advantage. Private equity should also benefit from an increasing number of new issues and a healthy and more liquid secondary market.

In sum, its seems plausible to suggest that, with forecasts of adequate world economic growth (the IMF estimates GDP of 4.4% for 2011), equities both in the UK and globally will, between now and the end of the year, outperform fixed interest and achieve increases for the calendar year as a whole of , say 7 to 9%. Supportive factors for equities should continue to be the raising of substantial funds through IPOs, especially in the USA and a surge in CAPEX together with earnings and dividends increasing faster than inflation. The IMF added "the recovery has become more self sustaining, risks of a double-dip recession in advanced economies have receded, and global activity seems set to accelerate again". The outlook for traditional fixed interest stocks will most likely remain clouded by interest rate increases both expected and actual. However, the derivative and absolute return products of a fixed interest portfolio should serve to enhance overall return. This is a theme which is becoming increasingly popular with fixed interest investors.

As mentioned in past quarterly reports, the long term performance of pension funds appears likely to become increasingly reliant upon a high degree of globalisation (to include emerging market equities and debt) amongst all of its asset classes. In that regard it is a bonus that some 65% of FTSE 100 company earnings and asset ownership is estimated to be international. Of increasing importance will be adequate investment in minerals and energy sources; be it in oil, liquefied natural gas and coal.

This does not assume that nuclear reactors will become extinct, but simply that the new ones will have to be constructed to much higher safety standards than heretofore.

12th April 2011

Investment Update for the Month of April 2011

The index returns and exchange rate movements for the month of April are shown in the tables below.

	Indices	Month ended 30th April 2011
		%
Equities		
Europe	FTSE Developed Europe (ex UK)	4.4
UK	FTSE All Share	3.1
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	1.4
Emerging Markets	MSCI Emerging Markets Free	-0.9
North America	FTSE North America	-1.2
Japan	FTSE Developed Japan	-3.5
Fixed Interest		
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	2.1
UK ILGs	FTSE British Government IL Over 5 years	2.1
UK Gilts	FTSE British Government All Stocks	1.9
Property	IPD	N/a
Cash	Merrill Lynch LIBOR 3 Month	0.1

Currency movements for month ended 30th April 2011

Currency	31st March 2011	30th April 2011	Change %
USD/GBP	1.603	1.668	+4.1
EUR/GBP	1.130	1.124	-0.5
USD/EUR	1.419	1.484	+4.5
YEN/USD	82.880	81.140	-2.1

With quite so many economic concerns in the UK, the USA and parts of the Eurozone it is not surprising that market returns for the month of April were subdued by comparison with the quarter ended 31st March 2011. Understandably Japan was the worst performer (-3.5%) as it struggled to cope with the aftermath of its natural disasters. North America (-1.2%) reflected, above all else, the political problems in agreeing a solution to the massive deficit. The Emerging Market return was a negative 0.9% as investors appeared to seek more risk free alternative markets in uncertain times. On the plus side, the return from Europe was a most worthwhile +4.4% on the general assumption that the Eurozone was at last on the way to solving the problems of its peripheral member countries and that the Euro would remain intact. The UK return (+3.1%) should be seen in a particularly resilient light in view of the austerity programme and political bickering ahead of the local elections. Asia/Pacific managed a +1.4% return as it continued to be perceived, in general, as an area of superlative economic growth, especially in the longer term.

All three fixed interest sub sectors produced very acceptable positive returns around the 2.0% mark. There was evidence during the month that worried and more risk averse investors had sort the perceived safe haven of this asset class.

Property continued its steady improvement (+0.9%). Although this was admittedly for March as the IPD property index is not yet available for April. Although there is no reason to believe that the even tenor of the recovery will not be maintained.

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

- Certain minerals continued to strengthen with gold reaching a record $1,569 on 29th April. Earlier in the month silver rose to $46.76, its highest level since 1980, representing a 64% rise since 1st February. The higher the rises in these two markets the greater the apprehension that a bubble might be emerging.
- Currency markets were extremely volatile, as evidenced on 20th April with the US dollar falling to its lowest level for 16 years against a basket of currencies.
- Certain North African and Middle Eastern countries continued to give cause for great international concern.
- The global purchasing managers' index receded to 55.8 in March from 57.4 in February. Part of this fall was blamed on trade disruption caused by the disasters within Japan.
- As time goes by the market regulators are quite rightly coming in for more and more criticism for their lack of action and involvement, particularly during and after the post sub prime financial crisis. There seems little doubt that in the future regulators will have to become much more transparent and overt within their operations.

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

UK

- The coalition government was preoccupied with the forthcoming referendum on alternative voting. In this regard it was the press and other commentators who attempted to fan the flames of dissent and rift. The government continued along its arduous course of applying harsh remedial medicine to the economy. These measures are gradually being accepted by the electorate as it is realised that there really is no alternative if the appalling deficit is to be reduced and the economy improved.
- The manufacturing sector purchasing managers' index reduced to 54.6 in April down from 56.7 in March. This compares with a record level in January of 61.7.
- The Treasury increased its supplementary tax on North Sea oil and gas products from 20% to 32%. This tax rise may well have to be revisited.
- The Office for National Statistics reported that the rate of GDP for the first quarter of the year was up 0.5% which merely negates the negative figure for the previous quarter. This disappointing figure was blamed both on the high cost of energy together with bad weather conditions.
- High yield bond issuance has increased sharply as companies seek to refinance their levels of debt.
- In the first quarter of 2011 company dividends are estimated to have risen by a heartening 10% p.a.
- In the 3 months to February the unemployment figure reduced by 17,000 to 2.48M with the jobless rate inching back to 7.8% from the previous quarter's 7.9%.

- On 12th April sterling fell to its lowest rate against the euro for 6 months.
- In March the Consumer Price Index fell to 4.0% from 4.4% in February, still double the Bank of England's target.
- Sir John Vickers, acting for the Independent Commission on Banking, stated that his principal theme is to ring fence UK banking operations and to compel banks to hold more capital.

USA

- The Standard & Poors rating agency issuance of a clear signal that it might have to down grade America's triple A status acted as a severe jolt to the impasse between the Democrats and the Republicans as they have striven without much success to agree the vital budget measures so urgently needed to reduce the unacceptably high deficit and to inject the economy with a sufficient amount of adrenalin in order to shock it into a meaningful recovery. A feature of the month was the weakness of the US dollar and the increasing suspicion that the White House together with the Federal Reserve might have a hidden agenda to maintain a weak dollar to better boost exports and trade in general.
- The Institute for Supply Management's index of manufacturing activity decreased to 60.4 in April from 61.2 in March.
- The "Rust Belt" states have experienced the largest gain in manufacturing jobs as industrial activity recovers.
- On 28th April, as expected the Federal Reserve Board (FED) held interest rates. As a result of the FED's continuance with its easy money policy it is unsurprising that this stance has severely weakened the dollar. On 29th April, Bernanke at the FED said that it was intended to hold interest rates close to zero "for an extended period". Bernanke also confirmed that the second programme of quantitative easing would be completed.
- The status of the US dollar as the world reserve currency is being impacted by the increased standing of China's renminbi currency.
- On 28th April it was announced that the rate of GDP grew by 1.8% p.a. in the first quarter of 2011 compared with a rise of 3.1% p.a. in the previous quarter. This disappointing result was blamed on high energy prices, adverse weather and a drop in private sector spending.
- The Commerce Department reported that new orders for durable goods advanced by 2.5% in March (February +0.7%). This was much better than expected.
- As mentioned, the Standard & Poors rating agency reduced its outlook on US Sovereign Debt for the first time. The agency kept the credit rating at AAA, but cut the outlook from stable to negative. A negative definition equates to a one third chance of a downgrade in the next two years. This could further damage the US dollar's standing as a global reserve currency.
- Retail sales increased by 0.4% in March representing the ninth consecutive increase. This increase was nevertheless considered to be weaker than expected.

Europe

- On 7th April the European Central Bank, under the leadership of Jean Claude Trichet, raised interest rates by ¼% to 1 ¼% and indicated that further increases might follow. This is a clear attempt to pre-empt inflation. This was no surprise as the rise had been widely signalled. The Bank stated that acting against inflation was “in the interests of all members and partners of the single European market and single currency”. It also stated that the increase would help boost economic confidence. The economic state of Ireland, Portugal and Greece continued to be dire with all of them sucking in more financial aid, thanks to the continuing efforts of the ECB and the International Monetary Fund. In the longer run, it does appear inevitable that the Eurozone is likely to have a two tier system, but still retaining the Euro. At this time it does appear that Spain and Italy have financial problems, but they cannot be compared with the aforementioned triumvirate of disaster economies.

- The Spanish rate of unemployment in the first quarter of the year was 21.3% of the population (previous quarter 20.3%).
- The German Federal Labour Office reported that the number of unemployed people dropped by 37,000 to 2.97M in April.
- Glencore, a Swiss based corporation, and the world’s largest commodity trader, is soon to float valuing the company at some $60B.
- The Eurozone’s headline inflation rate for March was revised up to a two year high of 2.7%.
- Throughout April, it became increasingly apparent that Portugal needed an international rescue to avoid a sovereign bond default.
- The Eurozone’s purchasing managers’ index for March receded to 57.5 from 59.0 in February.

<u>Japan</u>

- There are signs that the economy and the country as a whole are gradually making a recovery from the devastating earthquake and tsunami. The resilience and determination of this nation is to be admired as it struggles to restore vital industrial supply lines for exports round the word e.g. for car components and electronics.
- On 28th April, as expected, the Bank of Japan held interest rates.
- The Government’s production survey for April and May expects manufacturing output to increase by 3.9% and 2.7% respectively.
- Factory output fell by 15.3% in March, the biggest fall since records began in 1953. Household spending fell 8.5% due, in part, to Japan’s natural disasters.
- The Bank of Japan said “the economic outlook greatly depends on when and what pace the various supply side constraints, including power shortages, are resolved.
- Tokyo Electric Power Company (TEPCO), the operating company of the Fukushima nuclear complex, estimates that the crisis could take 9 months to resolve. TEPCO supplies 29% of Japan’s electricity to more than two million businesses and twenty-six million households in the Tokyo metropolitan area. The government’s economic minister warned that the impact of the earthquake and the tsunami could be worse than had been initially thought. The Japanese global supply disruption caused Toyota and Ford to shut various plants. On 12th April the Japanese nuclear authority raised the severity of the Fukushima disaster to the highest level of 7.

<u>Asia/Pacific</u>

- China continued its programme of increasing interest rates in order to battle inflation. China has also increased its global influences both in regard to its holding of foreign reserves and deals that it effects for increasing its access to vital energy and mineral resources. The economy benefits both its regional neighbour economies and those further afield by its vast appetite for foreign goods. For instance vehicle manufacturing and cosmetic companies. China's booming middle classes act as a magnet to foreign suppliers of high quality goods and services.

- Headline inflation in India rose to 8.9% in March (February 8.3%).
- Chinese consumer prices increased by 5.4% p.a. in March.
- On 4th April, the People's Bank of China raised its benchmark one year lending rate by ¼% to 6.31% and its deposit rate to 3.25%. These were the fourth rises in 5 months.

Emerging Markets

- It is becoming apparent that whilst the BRIC economies (Brazil, Russia, India and China) are growing at a much faster rate than their counterpart economies in the Western Hemisphere, the CIVETS (Columbia, Indonesia, Vietnam, Egypt, Turkey and South Africa) economies are generally growing faster still.

Conclusion

So, whither the equity markets between now and the end of 2011? Most likely they will wax and wane according to the general perception of interest rate and inflation directions. With regard to the former it seems likely that, in the UK and USA interest rates, will remain at their current very low levels for longer than was generally anticipated only a relatively short while ago. Earlier in the year, the ECB signalled more incremental rises of ¼%. However, more recently, the bank has become more cautious and for the near future appears to have postponed interest rises to the late summer. Further afield, interest rates are likely to increase especially in China, Australia and other Asian nations. It should not be forgotten that both institutional and private investors still have relatively high levels of low yielding cash which are likely to be committed to further purchases of attractively priced high yielding equities and also corporate bonds.

With the caveat of the worrisome deficit resolutions in the UK, USA and peripheral Eurozone countries and the proviso that overall world economic growth levels do not deteriorate, then it seems reasonable to assume that the principal opinions contained in the investment report for the quarter ended 31st March 2011 still hold good. That is to say, in most regions, equities should achieve single digit returns for the year whilst outperforming fixed interest markets for which the outlook remains relatively lacklustre. If this general forecast does not materialise it will most likely be because global economic growth falters, particularly in the Western Hemisphere or that inflation rises are worse than forecast. Broad and large, the estimates for the other asset classes also remain relatively unchanged since a month ago. Currently the financial media are suggesting that a bubble is emerging in commodities. Granted they are expressing a severe short term speculative downdraught, but the long term attractions for this asset class are still in place, particularly in the case of hard commodities with finite reserves.

Valentine Furniss
11th May 2011