APPENDIX 6

REPORT ON INVESTMENT OPTIONS PREPARED FOR

London Borough of Bromley

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The brief

To prepare a paper setting out various investment alternatives in respect of the potential investment of between £10m and £30m for periods of between 3 and 5 years for submission to the London Borough of Bromley ("LBB") Cabinet. These investments may include Diversified Growth Funds or Property Investment Trusts and other long term strategies deemed appropriate and which fully satisfy the LBB treasury mantra of Security, Liquidity and Yield. This paper will highlight minimum time frames for the investments to achieve their stated return objectives, the levels of risk measured against investment return and the timeframes by which the chosen asset classes can be fully invested.

The current market

The "Lehman crisis" in 2008, almost brought down the global financial markets, and resulted in Central Banks taking unprecedented actions to both pump liquidity into the markets and to vocalise their intent to do whatever was necessary to achieve financial stability. The long term effects of this "crash" and the "antidote" of highly managed monetary policy remain with us, albeit in a less overt sense.
Currently, central bankers are quietly managing the nascent economic recovery in the developed world and considering what steps, if any, might be necessary to avoid stagflation or deflation in Europe, a burgeoning property market in the UK and a patchy but growing recovery in the USA. These activities are in parallel with slowing growth in China and concern over the stability of some emerging market economies. In addition, questions remain as to the process by which this monetary easing might be removed from the global economy.

The Bank of England base rate has been held at 0.5% pa since 2009, an unprecedented period of no change, and one which reflects Bank of England concern for the UK economy. As a result of this activity, bank deposit rates are low, with returns below the current rate of inflation.

In recent times there has been talk from some central bankers that rates will rise at some stage but not until at least 2015 and then only in response to economic pressures to perhaps dampen inflation potential or a "bubble" in particular market segments.

As a result, treasurers looking to invest funds surplus to their current requirements have been considering other investable assets, which at least provide a rate in line with inflation. These rates are not achievable through bank deposits or even through investment in gilts or index linked government bonds. Treasurers have and are investing in assets which may previously have been deemed too long term in nature for the corporate sector, but which have been part of the historic asset allocation of pension funds in order to achieve returns over inflation and partly to match scheme liabilities.

These assets are typically designed to show positive returns over at least one economic cycle, which effectively means the investment need to be held for a minimum period of between three and five years in order for the investment philosophy driving the investment returns to flow through**.**

What type of investment vehicles are currently available

There are various asset classes available for investment, each with its own particular risk/return characteristics:

i. Diversified growth funds
ii. Property investment trusts
iii. Alternative investments including Private equity

Investment Market developments

In the late 1980's and early 1990's pension funds began investing in what were known as "balanced" funds. The pension fund placed funds with an investment manager who then allocated it to various asset classes and in various countries, thus a typical asset allocation might have been:

80% in equities invested in the UK, USA, Europe and Japan, with perhaps a very small amount in Pacific Rim ex Japan
20% invested in fixed interest bonds with a significant holding in UK Gilts, US T Bills and maybe some investment grade corporate bonds.

This fund would have been measured against an index of balanced managers rather than against a target rate of return set by the pension fund.

In the late 1990's pension funds started to move away from balanced funds towards specific investment mandates which overall, had a target return and which was not simply a comparison to other funds. In the mid to late 2000's several investment managers took their old "balanced" funds and reinvented them as diversified growth or real return funds. By taking the concept of manager driven asset allocation but adding a target rate of return and benchmark, investment managers marketed these funds to small and medium pension schemes and charities where trustees had little investment expertise and little time to make asset allocation decisions.

Property investment trusts more commonly known as Real estate investment trusts or "REITs")

Originally established in the USA, REIT's were established in the UK at the beginning of 2007, with some of the biggest UK property companies converting to REIT's as the tax structure was extremely attractive. There are now nearly 50 REIT companies established in the UK

REIT's are better described as **equities or common stock in a listed company** which invests in property, and thus offer the investor an equity like return (and equity like risk) in return for liquidity. Most REIT's are listed on the Stock Exchange and whilst some investors use REIT's as a proxy for direct property investment, it provides them with a liquidity based return rather than attracting the "illiquidity premium" through investing in either direct property or through a property unit trust. However, as part of the FTSE All Share Index, REIT's react not only to broad stock market changes but also market driven perceptions of movements in value in the property market.

Great care must be exercised through due diligence, in determining the extent to which the REIT is diversified across the different property sectors (office, retail, retail distribution and warehousing, residential and others), as a particular concentration in one sector or region could prove expensive.

From an investment return perspective the REIT sector as measured by the FTSE Actuaries share indices has a running yield of 3.25% pa Thus when measured against the Liquidity, Security, Return mantra of LBB, an investment in a REIT has liquidity as the shares can be purchased or sold on a typically T plus 2 days settlement basis.
It's security is the perceived value of the property assets held within its portfolio. The investment return ie dividend stream, is adequate and above the current rate of inflation, however, from a relative risk/return perspective the asset is an equity and therefore subject to the vagaries of the market place.
Chart 1 on page 4 indicates a risk or volatility level of 12.1% pa for the FTSE ALL Share index when measured over a three year period.

Investors can also gain exposure to commercial and retail property by **purchasing units in pooled vehicles ("OEIC's) investing solely in property assets**. Once again these do not offer the same "illiquidity premium" returns that are available through direct property holdings as they are usually traded on a bid and offer spread price.

In most cases investors wanting to redeem units will submit a redemption request which will be executed and proceeds paid out after 3 months. Note that with some managers there is a subscription charge and a redemption charge in addition to the bid and offer spread around the last net asset value calculation.
Typically a managed fund will carry a cash buffer from which to make redemptions. In certain instances, and certainly in recent years, significant investor redemptions have forced managers to impose a "waiting list" for client redemptions pending sales of property holdings enabling those redemptions to be made. In some extreme cases managers have imposed additional exit levies in order to protect those investors remaining in the funds and in one very recent case, investors were forced to accept a 12 month moratorium on redemptions in order to save the fund from going into liquidation.
However, whilst they basically fulfil two of the three requirements namely return and security, as far as liquidity is concerned, the investor will have to wait a minimum of 3 months to get paid out and in some cases much longer should the fund be subjected to significant redemption request.

Direct property investment is not an option for LBB as the size of the potential investment as evidenced in "The Brief" on page 1 is not large enough to provide sufficient diversity of holdings both sectorally and geographically. In any event the potential illiquidity risk would also rule direct property out.

Corporate bonds

Bonds issued by investment grade corporates have done well over the longer term, but in recent months, as talk of interest rate rises becomes commonplace, they have lost some of their lustre and whilst still returning a margin over gilts, would appear to be fully valued at the present time. An interest rate rise would impair their capital value and whilst they are currently meeting two of the three criteria, liquidity and security, they must be deemed a failure as regards return.

Chart 3 Corporate bond investment returns

Period		1Q 14	12months	3years	5 years
number of funds		56	56	56	55
		% return	% return	% return pa	% return pa
Upper Quartile		2.8	1.7	8.0	10.8
Median		2.5	-0.3	6.8	8.6
Lower Quartile		2.1	-2.3	5.6	5.0

Source: BNYMellon P&RA E ltd

Asset backed securities have much in common with corporate bonds although the investment returns may be slightly higher, potential capital losses from a future interest rate hike make these investments currently less attractive.

Alternative investments

Alternative investment opportunities such as infrastructure, private equity, private debt and asset backed securities are all available to the investor through a mixture of open or closed end investment funds. One of the drawbacks from LBB's perspective of investing in ***alternative assets is the mean time between committing to invest and being fully funded.***

For **private equity** as an example, becoming fully invested can take several years and then an investor has to wait for investments to be realised and cash returned, before a rate of return can be calculated.
Whilst returns can be extremely attractive, the investment is effectively illiquid until realised as there is only a very limited secondary market.

Infrastructure funds operate in similar way to private equity in that the commitments are made and then periodic drawdowns are made. Whilst the drawdown period is usually less long than for private equity, these investments are effectively illiquid until they mature.

"Capital release" funds are another investment opportunity which almost meet the criteria, but again do not meet the liquidity requirement as they would generally take between twelve and 18 months from commitment to full drawdown and would then have an average repayment life of approximately four years. During that time the investment is essentially illiquid until maturity.

For these particular reasons an investment in private equity, infrastructure or capital release funds does not meet the three criteria set by LBB, especially in terms of liquidity.

Diversified growth funds

As mentioned on Page 2, “DGF” funds emerged around ten years ago as a means whereby smaller funds, in particular, could obtain exposure to a broad range of assets and a reasonable rate of return, but with a lower level of risk, or volatility than equities. These smaller funds who had limited governance capacity were able to delegate asset allocation and timing decisions to the investment manager. More recently larger pension funds also began investing in them as a risk mitigating investment and also where they wanted to gain exposure to alternative investment classes without having to go through lengthy and costly procurement processes.

In more recent times, corporate treasurers and finance directors have also been investing in these funds as an alternative to cash deposits in order to improve their returns whilst managing down risk levels.

These funds comply with the LBB Treasury mantra of Security, Liquidity and Yield

Security

By selecting managers who have a long and stable track record in managing these products, coupled with an asset pool which is reviewed on a regular basis for liquidity, investors have been able to achieve a return similar to that of equities but with less than 50% of their volatility.

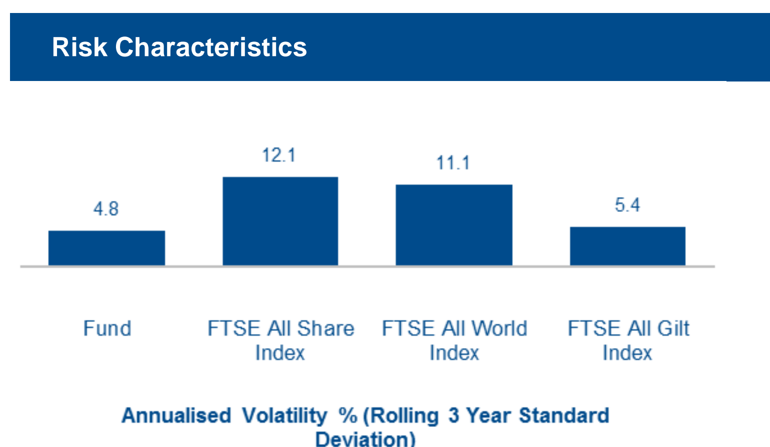
Liquidity

Most diversified growth funds trade on a daily or weekly basis with settlement on a trade plus 2 days. It is worth noting that there have been no temporary closures or delays in settling client disinvestment requests. On the contrary, in recent times several managers have closed their funds to new business as they recognise that growing assets is not the same as making sure their existing investors continue to benefit from the manager’s long term investment philosophy.

Yield

Investment returns over the last five years have confirmed that these funds have been very successful in capturing investment return whist maintaining a relatively low risk profile when compared with equities. (see chart 1 on page 7 on risk characteristics). Investment returns over the last twelve to 18 months have been lower as markets settled into a risk on /risk off mode, as markets and investors pondered the next monetary move from the central banks. (See chart 2 on page 7).

Chart 1



Source:manager report for 1Q 2014 from internet

Chart 2

Period to 31/3/14 Manager		quarter	1 year	3 year % pa	5 year % pa
1*		-0.5	1.6	4.7	9.3
2		0.7	1.1	3.9	6.8
3**		0.7	1.1	5.1	13.3
4		0.2	3.3	5.9	9.3
5		0.3	5.2	4.2	11.2
6		0.9	5.7	4.6	8.5

Source: manager reports from internet

*Denotes soft closed
** Denotes hard closed

The above investment return table provides an indication of how broadly returns can differ over time, even though the risk or volatility factors have a fairly narrow range of 6.2% to 4.5%. Roughly 1/2 to 2/3 the risk associated with equities.

In terms of the relative risk or volatility profile ranges, the majority of the funds listed in the table above were in a very tight range of just 4.5% to 4.9% confirming that risk minimisation, or preservation of capital, is one of the key investment management elements within each fund.

As far as elapsed time from appointment to funding is concerned this should take no more than four weeks as the investor has only to complete a “subscription Agreement”, authorised signature lists and various money laundering documents.

Summary

There are a significant number of different asset classes in which LBB could invest and which, when realised would be likely to show strong positive returns, however, the period in which the funds might be available for investment viz three to five years and the L B B mantra of **Security, Liquidity** and **Yield,** severely restricts the opportunities remaining available.

Cash deposits do remain a viable proposition, although this paper has not commented on them, as they would certainly qualify under two of the three criteria but would fall when yield considerations were taken into account.

Diversified growth funds, in the writer's opinion tick all three boxes.

Security in the sense that investments are made in highly liquid asset classes by investment managers who have spent a long time developing and refining their investment and risk management practices, **liquidity,** with daily or weekly dealing and finally **yield** where the returns, over a three year period to end March 2014 have been in a range of 3.9% pa to 5.9%pa. The additional measure, not included in the LBB mantra is the anticipated or actual levels of risk taken in order to achieve these returns. **The actual risk or volatility** as investment managers like to call it has, in the six examples taken, moved in a range of 4.5%pa to 4.9%pa with one outlier at 6.2%pa. A risk level of approximately 40% of the FTSE All Share Index and 43% of the FTSE All World Equity Index when measured over the same three year period.

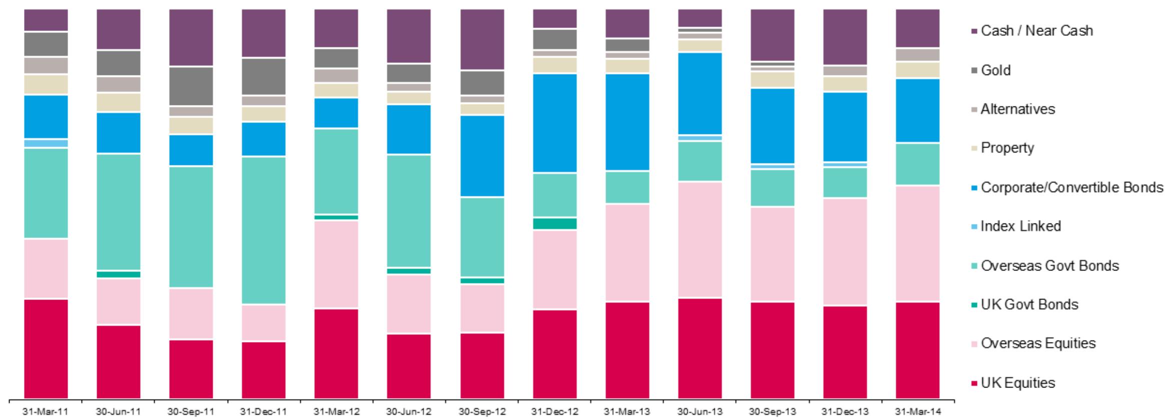
Recommendation

LBB should consider an investment in a minimum of two investment managers offering diversified growth fund products, but who have clearly contrasting or complimentary investment styles; providing LBB can accept that diversified growth funds are essentially relative value global investment strategies working over at least a full economic cycle (viz three to five years) and that any recall of funds before the three to five year period has elapsed will affect the overall return.

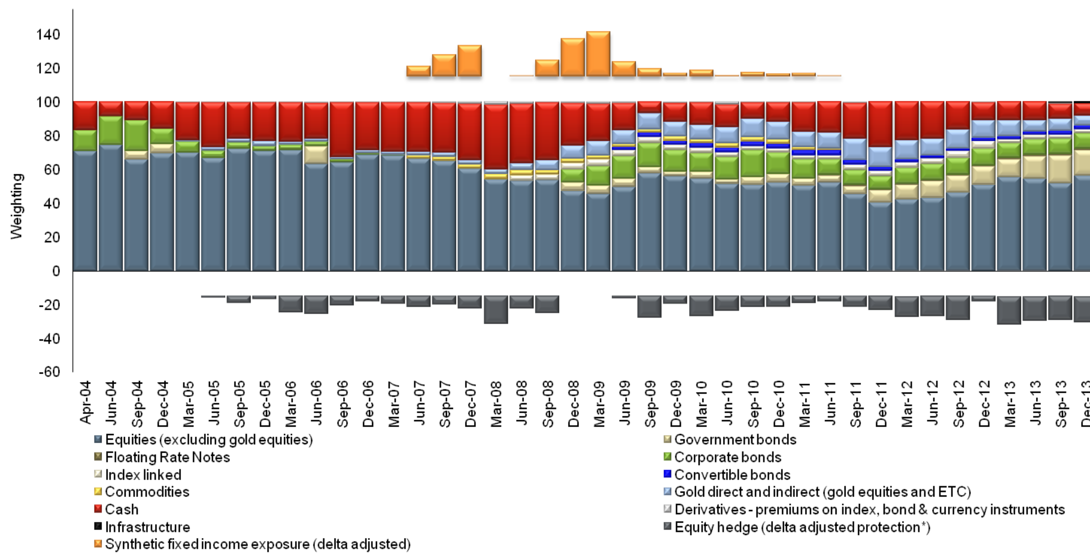
APPENDIX A

The two "pie charts" below highlight the asset allocations of two different DGF managers.

A typical "sandbox" demonstrating how one manager has changed asset allocations over time



Another "sandbox" chart from a different DGF manager



The two "pie charts" below indicate how two managers set their asset allocations at 31 March 2014