

EXECUTIVE COUNCIL

CONFIDENTIAL

Title of Report: Review of Government Investment Strategy

Paper No: 35/10

Date: 25 March 2010

Report of: Director of Corporate Resources

1. Purpose

1.1. To inform Exco of the recommendations from the professional investment advisors for decision on key aspects of revision to the FIG's investment strategies, as a basis for work to progress.

2. Recommendations

To agree amendment to fund management strategies as indicated at item 6 and summarised in the table below (or to indicate alternate preferred options) and to agree that the detailed guidelines be updated accordingly.

Summary of recommended benchmark percentages and permitted investments:

		Equity	Equity	Prop-	Bonds	Bonds	Bonds	Bonds			Commo	
	Fund	UK	O'seas	erty	Gilts	Indexed	Global	Corp.	Cash	Hedge	-dities	
(a)	Growth	Current	50	✓	0	50	✓	✓	✓	✓	0	0
		Rec	30	30	15	10	✓	✓	15	✓	✓	✓
(b)	Pensions	Current	50	20	0	15	14	✓	✓	1	0	0
	(RPEF)	Rec	35	35	10	10	✓	✓	10	✓	✓	✓
(c)	Pensions	Current	10	0	0	0	90	0	0	0	0	0
	(POSF)	Rec	5	5	0	0	90	0	0	0	0	0
(d)	Insurance	Current	0	0	0	✓	✓	100	✓	✓	0	0
		Rec	0	0	0	100	✓	✓	✓	✓	0	0

Note: ✓ Ticks show permitted investments that are not specifically included in the benchmark.

3. Summary of Financial Implications

None at this stage. The cost of the investment management review is budgeted and if the recommendations are accepted average annual returns should improve by over £1m. However, only part of this sum relates to the Growth Fund, and with declining global returns this is unlikely to represent any increase to current investment income budgets, which could otherwise need significant reduction.

4. Background

- 4.1. FIG has built up significant funds over the years, particularly from fisheries income and the funding of pension and insurance schemes. These investment funds now total over £160m. Each fund has specific guidelines relating to its purpose. In 1998 management of the funds was split between HSBC and Newton (which had previously been responsible for the entire portfolio).
- 4.2. In view of changes since 1998 and the uncertainties of global markets going forward a review of investment guidelines and management arrangements has been commissioned from 'Jewson Associates' investment consultancy. Their overall remit is to review the fund management guidelines and investment management arrangements in order to optimise the risk/return balance, in the context of the differing demands on each fund and global financial developments.
- 4.3. A summary of the advisers Investment Strategy Review is attached as an appendix (the full document is also available). Implementation of any agreed strategy changes will take some time, as the detailed guidelines and permitted ranges will need corresponding amendment and investment re-allocation will need to be phased in and co-ordinated with possible changes to investment managers.

5. Overview of advice

- 5.1. There are two main aspects of risk addressed in the review on which FIG needs to assess an appropriate balance. These are (a) the return obtained on investments and (b) the volatility of investment values. For example, comparing cash with shares, over time cash is likely to give much lower returns, but unlike shares the capital value of cash should not vary from day to day. The risk with cash is primarily from poor returns failing to keep up with inflation, whilst with shares the risk is from fluctuating values. Provided the investment is for the long term and returns remain adequate, an element of volatility should be acceptable.
- 5.2. The advisers see the greatest long term risk for FIG being loss of investment value over time due to returns being less than inflation. They also consider that gilts will be potentially more risky in future, because of the likelihood of interest rates rising (which will reduce the capital value of gilts). In the past declines in equities have been offset by gains on gilts, but this favourable combination is much less likely in the future, as interest rates are likely to rise from the current historic lows.
- 5.3. Most of the recommendations involve adjusting the weightings of existing permitted investments within the benchmarks, but additional permitted investments are recommended to provide diversification within the Growth and Retirement Pensions Equalisation Funds.
- 5.4. Overall FIG investments are (and will remain) mainly in assets with relatively low returns and relatively low volatility, but the proposals recommend an

5.5. In the context of the entire £160m of funds, the recommendations for changes to benchmark allocations of investments (against which the managers' performance is assessed) would involve:

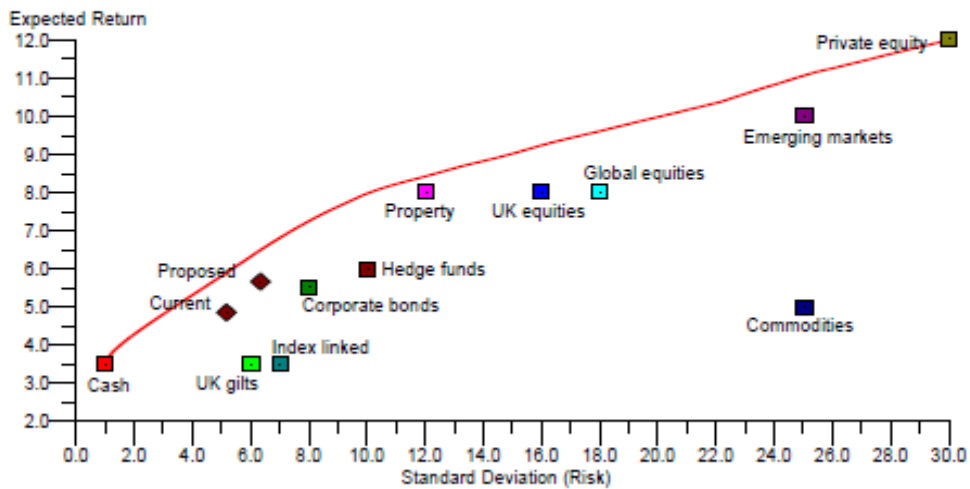
- an increase from 30 to 34% equity,
- inclusion of a 7% investment in commercial property and
- allocation of 7% to corporate (as opposed to government) bonds.

The overall profile is shown below.

Table 1	Percentages		Bonds:	Bonds:	Bonds:	Bonds:	
Asset allocation	Equities	Property	Gilts	Index Linked Gilts	Global	Corporate	Cash
Current	30	0	36	9	16	0	9
Proposed	34	7	36	7	0	7	9

5.6. This repositioning is projected to increase returns from 5.0 to 5.7% and volatility from 5.2 to 6.35%. The figure below shows the expected return and volatility for the FIG portfolio as a whole (before and after recommended changes) in comparison with a wide range of potential investments. The red line shows the 'efficiency frontier' which is the maximum return obtainable at any given level of volatility by holding a diversified portfolio of investments. According to this, the overall portfolio will have a similar volatility (6-7%) to holding gilts (which have expected returns of 3.5%) whilst giving a significantly higher return of around 5.7%.

Seven funds combined



5.7. Considering the full £160m of FIG investments, the predicted most extreme loss (worst 2% of cases) in any single year increases from 5.4% to 6.9%. Although future behaviour is not expected to be the same as in the past, on a historic basis the maximum drawdown would have been increased from 9.2% to 12.8%. The figures on Table 2 show that the most extreme predictions for returns from the RPEF and Growth funds range from -16% to +31%. This is in line with the current range for the RPEF (-16% to +29%), but rather more than for the current Growth Fund (-10% to +22%). However, after the changes the Growth Fund would still have a lower volatility than the current RPEF investments, whilst giving a higher return.

6. Specific Recommendations:

6.1. No changes were considered appropriate for the Currency, Capital Equalisation and Income Funds (totalling £34m).

6.2. The main recommendations for change related to the Growth Fund and the Retirement Pensions Equalisation Fund ('RPEF'), which are the main 'multi-asset' funds. The recommendations are summarised in Table 2. The advisers have provided two options (A and B) for each fund, but recommend option B. Taking into account comments from Oliver Larminie (the FIG client Manager at Newton) options B have been slightly modified to provide the B2 options which are recommended for Exco approval. The changes should decrease the volatility of the original proposals. Following agreement on benchmarks, supplementary work will be needed with the adviser and the appointed managers to establish appropriate ranges for each category of investment.

6.3. The proposals for changes to the Growth Fund and RPEF are:

6.3.1. Increasing the equity proportion in the Growth Fund from 50 to 60% (but making no change to the equity level within the Pensions Fund which already has 70% equity).

- 6.3.2. Specifically allocating part of the equity benchmark to overseas rather than UK equities. Following consultation with Newton the recommended options (B2) keep half of the equity allocation to UK equities and do not make any specific allocation to emerging market equities (although investment is permitted at the manager's discretion). Compared to option B this change increases the sterling link in the portfolio and is likely to reduce volatility with little impact on returns compared to the original recommendations.
- 6.3.3. To note that overseas investments will not be required to be hedged unless overseas exposure is in excess of 60% of the fund, as hedging adds to complexity and sterling is considered quite likely to decline against other currencies, in which case there could be additional benefits from unhedged overseas holdings.
- 6.3.4. Corporate bonds are already permitted holdings, but have been added specifically to the benchmark at 15% for the Growth and 10% for the Pensions fund (reducing the allocation to Gilts). All bonds still need to have good credit ratings, and although corporate bonds do not have the same backing as Government bonds they are expected to offer a better risk/return ratio.
- 6.3.5. Commercial property is proposed to be invested in for 15% of the Growth fund and 10% of the Pensions fund (around £11m in total). Compared to Gilts, this is expected to give considerably higher returns and protection against inflation (from future rental increases) but it is a more volatile and less liquid asset.
- 6.3.6. Although not proposed as part of the benchmark, hedge fund and commodity investments should be permitted on an ad hoc basis for up to 10% of the Growth and Pensions Funds. This would allow managers access to additional opportunities and help to diversify holdings at times when other asset classes may be at risk.
- 6.4. The Pensions Old Scheme Fund '(POSF') and Insurance Fund have relatively minor changes recommended:
 - 6.4.1. The POSF currently has a 10% allocation to UK high yielding equity. The 10% allocation to equity should remain, but be allocated on a 50% worldwide benchmark basis, in line with the strategy for the other equity investments.
 - 6.4.2. Insurance Fund: This is to remain 100% invested in Government bonds, but to keep a consistent policy across the investments (and to simplify arrangements) the advisers recommend switching the strategy from allocation to Global Government bonds to UK gilts. This will avoid the need to provide currency hedging.

7. Newton's comments

- 7.1. In order to provide additional scrutiny, a third party opinion has been sought from Oliver Larminie (FIG client Manager at Newton). He has made the following points:

- It is agreed that assumptions on future performance are in line with other work on the topic.
- It is agreed that the recommendations should provide a better return over the long term, but FIG need to be aware that there is some additional volatility involved and to ensure that possible falls in value are amounts that would be acceptable.
- It is agreed that gilt returns are currently low and that real returns on gilts going forwards are likely to be low, unless a period of deflation occurs. A relatively high allocation to equities is therefore reasonable.
- Worldwide equity investment is beneficial, but he would not suggest levels above 50% of the equity exposure in the benchmark for FIG. Because of the diverse nature of the UK market and the fact that 60% of the economic exposure of UK listed companies is from overseas, it is quite possible to get significant overseas exposure even from investments in the UK market.
- Whilst recognising the benefits of overseas investment, including emerging markets, the manager has concerns regarding any specific benchmark allocation to emerging markets. This is because of the limited markets, poorer regulation and reporting and the fact that a growing GDP is not necessarily reflected in stock market returns.
- The manager agrees that property has excellent income producing characteristics and offers a sensible diversification, considered on a 5-10 year time scale. With upwards only rent revisions income should increase. However, it is a relatively illiquid asset class and not particularly suitable to changing allocations. The manager would therefore recommend consideration of investment in property as a specific sub-fund rather than attempting frequent re-allocation.
- Hedge fund and commodity fund investment on an ad hoc basis also make sense.

8. Financial implications

- 8.1. Although review demonstrates that current guidelines have served well, this is mainly due to exceptional gains in bond values during the period, and with current low interest rates this cannot be repeated going forward - and may reverse. With worldwide investment and financial volatility and the likelihood of significant fluctuations in asset pricing and national economies, it will be increasingly important to have guidelines with sufficient flexibility on asset allocation to enable managers to reduce holdings of assets at times when they are considered likely to fall in value.
- 8.2. The review recommends changes which increase expected returns from 5 to 5.7% over the portfolio as a whole. This is equivalent to a £1.12m gain per annum on £160m, mostly relating to the Growth Fund, from which returns are used for direct budgetary support. However, improving returns on any of the Government funds should ultimately have an equal benefit on overall FIG funding requirements.

- 8.3. Given declining global investment returns, particularly to bonds and cash, the current projections of investment returns available for budgetary support have become quite optimistic, and are unlikely to be attained in future unless changes are made on the lines recommended.

9. Glossary

Corporate bonds: Debt instruments issued by corporations, supra national organisations and governments issuing in currencies other than their own (normally for periods exceeding 1 year).

Gilts: Debt securities issued by the British Government.

GDP (Gross Domestic Product): A measure of economic strength, assessed as the total monetary value of all goods and services produced domestically by a country

Hedging: Currency hedging involves taking measures to reduce the risk of currency fluctuation affecting the value of investments.

Index Linked Gilts (ILG): Gilts with future values indexed to inflation

Maximum drawdown is the maximum fall in value (peak to trough) measured over the past 10 years.

Multi-asset fund: A fund invested in a range of different asset classes.

Sharpe ratio: A ratio that allows comparison of returns against risk for different portfolios, with higher values indicating higher returns in relation to the level of volatility, in comparison to the return on cash.

Volatility: The volatility measurements assess the degree of fluctuation in investment values. The advisers have used monthly investment values to give a figure of one 'standard deviation'. Assuming a 'normal' distribution of returns, volatility would be expected to be within plus or minus 1 standard deviation (from average growth) 66% of the time, and 2 standard deviations 98% of the time.

10. Legal Implications

None

11. Human Resources Implications

None

Table 2: Strategy recommendations for the Growth Fund and Retirement Pensions Equalisation Fund (RPEF) – benchmark percentages

Asset classes	Growth Fund	Adviser options		Recommended Option B2	RPEF	Adviser options		Recommended Option B2
	Current	A	B		Current	A	B	
Cash	✓	✓	✓	✓	1	✓	✓	✓
Gilts	50	30	10	10	15	15	10	10
Index linked bonds	✓	✓	✓	✓	14	✓	✓	✓
Sterling Corp. bonds	✓	10	15	15	✓	10	10	10
Global bonds	✓	✓	✓	✓	✓	✓	✓	✓
<i>Bonds subtotal</i>	<i>50</i>	<i>40</i>	<i>25</i>	<i>25</i>	<i>30</i>	<i>25</i>	<i>20</i>	<i>20</i>
UK equities	50	10	10	30	50	20	20	35
Overseas equities	✓	35	40	30	20	45	40	35
Emerging equities	✓	5	10	✓	✓	5	10	✓
<i>Equities subtotal</i>	<i>50</i>	<i>50</i>	<i>60</i>	<i>60</i>	<i>70</i>	<i>70</i>	<i>70</i>	<i>70</i>
Property	-	10	15	15	-	5	10	10
Hedge funds	-	✓	✓	✓	-	✓	✓	✓
Commodities	-	✓	✓	✓	-	✓	✓	✓
<i>Alternatives</i>	<i>0</i>	<i>10</i>	<i>15</i>	<i>15</i>	<i>0</i>	<i>10</i>	<i>10</i>	<i>10</i>
<i>Sterling %</i>	<i>100</i>	<i>60</i>	<i>50</i>	<i>70</i>	<i>80</i>	<i>50</i>	<i>50</i>	<i>65</i>
<i>Historic max. drawdown</i>	<i>-17.6</i>	<i>-20.3</i>	<i>-26.4</i>		<i>-30.3</i>	<i>-31</i>	<i>-29.8</i>	
<i>Predicted:</i>								
<i>Annual return %</i>	<i>5.8</i>	<i>6.4</i>	<i>7.3</i>		<i>6.7</i>	<i>7.1</i>	<i>7.5</i>	
<i>Volatility %</i>	<i>8</i>	<i>8.9</i>	<i>10.6</i>		<i>11.3</i>	<i>11.7</i>	<i>11.9</i>	
<i>Annual min. return %</i>	<i>-10</i>	<i>-11</i>	<i>-14</i>		<i>-16</i>	<i>-16</i>	<i>-16</i>	
<i>Annual max. return %</i>	<i>22</i>	<i>24</i>	<i>29</i>		<i>29</i>	<i>31</i>	<i>31</i>	
<i>Sharpe ratio</i>	<i>0.288</i>	<i>0.326</i>	<i>0.359</i>		<i>0.283</i>	<i>0.308</i>	<i>0.336</i>	
<i>Maximum likelihood of 10% loss over 3 years</i>	<i>2%</i>	<i>2%</i>	<i>4%</i>		<i>3%</i>	<i>3%</i>	<i>2%</i>	

Note: ✓ Ticks show permitted investments that are not specifically included in the benchmark.

APPENDIX – SUMMARY OF INVESTMENT STRATEGY REVIEW

Jewson Associates have produced a full Investment Strategy Review of 58 pages (available separately) from which the basis for their recommendations is summarised here.

1. Background

1.1. The adviser has taken account of each fund's requirements separately rather than taking a global view of the full £160m available. However, they point out that ultimately these are all Government funds and if a view were taken on appropriate investments for the sums as a whole, this would be likely to result in a higher allocation to equities. Several funds are invested in cash or short term debt, and although others have a balanced approach, this results in the overall investment having a high weighting to cash and similar investments.

1.2. Over the long term, they consider that
‘the greatest risk for investors is inflation and that “real” assets, such as equities and property, provide the best protection against this. Nevertheless, over the past twenty years or so, the return from real assets has been disappointing compared to the return from monetary assets, such as government bonds. Looking forward, we expect the situation to revert to normal in that returns from real asset classes will be higher than those from monetary assets. Thus, where appropriate, we have recommended greater exposure to “risk” assets, such as equity and property, despite the fact that on historic data over the last decade this would have produced lower returns and higher volatility than your existing benchmarks.’

2. Underlying projections

2.1. The advisers expect that future investment performance will differ from that seen over the past 10 years, and their recommendations are therefore based on assessment of likely future performance (as shown below). They point out that, “the projections are ‘broad orders of magnitude’ rather than exact forecasts, as returns cannot be forecast with precision.” They also indicate that bond returns will be sensitive to changes (up or down) in inflation, whilst ‘real assets’ (shares, property) will be sensitive to changes in the GDP. They project typical rates of inflation of around 3.0% RPI for the UK and developed country real growth as 2.5%. (The UK RPI jumped to 2.4% in December then 3.7% in January, and world economies are currently returning to growth.)

Projected investment returns with historic comparisons

% p.a.	Projected returns		Historic real returns			
	Nominal	Real	10 yr	20 yr	50 yr	108 yr
Equities						
UK	8.0	5.0	-1.4	4.8	5.9	5.3
Global	8.0	5.0	-0.4	2.9	---	---
Emerging	10.0	7.0	8.1	7.8	---	---
Alternatives						
Private equity	12.0	9.0	---	---	---	---
Property	8.0	5.0	4.6	4.8	4.8	---
Hedge funds	6.0	3.0	2.8	9.5	---	---
Commodities	5.0	2.0	9.3	1.1	-2.2	-0.6
Bonds and cash						
Global government bonds	3.5	0.5	4.8	5.3	---	---
Sterling corporate bonds	5.0	2.0	2.0	---	---	---
Index linked gilts	3.5	0.5	2.6	4.4	---	---
Gilts	3.5	0.5	2.6	5.3	1.9	1.4
Sterling cash	3.5	0.5	1.9	3.3	2.3	1.0

Note: Historic data to end 2008 in sterling terms for headline indices; sources various (10 and 20 year data Bloomberg and Morningstar; longer term data source Credit Suisse Global Investment Returns Yearbook); there is no historic data for private equity consistent with other asset classes

Investment returns and their volatility

%	Annual investment returns 1988-2009			Volatility			
	Best	Worst	Average	3 yr	5 yr	10 yr	Forecast
Equities							
UK equities	36.1	-29.9	8.3	18.6	15.4	15.4	16.0
Global equities	31.2	-27.1	6.4	19.2	16.3	17.0	18.0
Emerging equities	85.0	-36.3	11.3	28.3	25.1	24.1	25.0
Alternatives							
Property	20.2	-22.5	7.2	6.5	6.5	4.9	12.0
Hedge funds	26.5	-20.7	13.0	7.9	6.8	6.2	10.0
Commodities	50.8	-30.1	4.6	23.8	23.8	23.5	25.0
Bonds and cash							
Global government bonds	55.2	-7.5	8.6	13.8	11.2	9.2	8.0
Sterling corporate bonds	14.6	-4.0	4.5	8.4	6.8	5.9	8.0
Index linked gilts	19.9	-7.0	7.9	9.9	8.0	6.7	7.0
Gilts	20.5	-7.5	8.8	6.6	5.4	4.8	6.0
Sterling cash	15.5	3.7	6.8	0.6	0.4	0.4	1.0

2.2. The advisers also undertook a series of historical comparisons and assessments of the various investment strategies. These were to provide additional information on possible portfolio characteristics. They were not, however, the basis for their recommendations, as there is an expectation that asset performance going forward will not be the same as over the past 10 years. In fact, investments giving the best performance previously could do the opposite in future.

2.3. The advisers recommendations also take account of the benefits of diversification, as investing in an appropriate range of assets can improve returns for any given level of volatility. Their estimates of correlation are shown in the table below. Correlation estimates the extent to which different assets will gain or lose value together. Investing in assets that are less correlated improves the stability and efficiency of a portfolio. This is illustrated by the figure at section 4 showing the “efficiency frontier” which is the maximum return obtainable for any given level of volatility through combining different assets (which generally exceeds that of any individual

asset).

Correlation coefficients

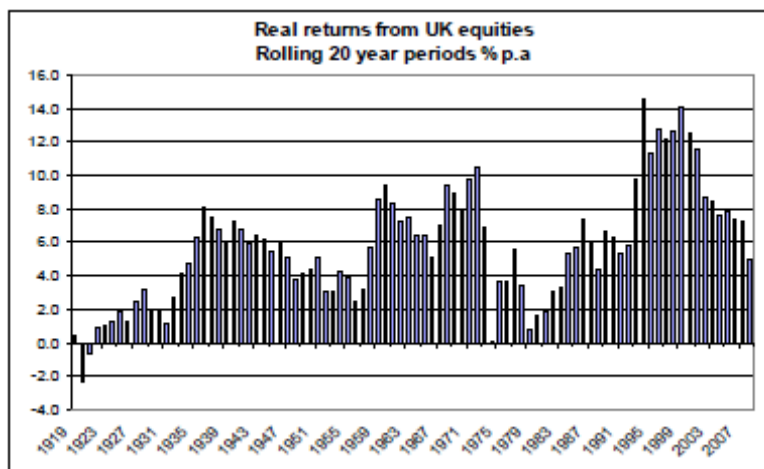
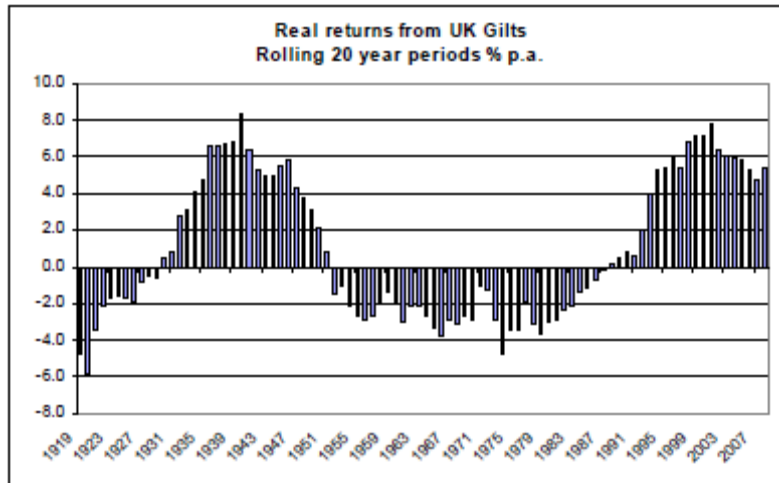
	Equities			Alternatives				Bonds			
	UK	Global	EM	PE	Prop	HF	Comm	Corp	Gilt	ILG	Cash
Equities											
UK	1.0	0.9	0.7	0.5	0.4	0.6	-0.1	-0.1	-0.2	0	0.1
Overseas	0.9	1.0	0.8	0.6	0.3	0.6	-0.1	-0.1	-0.2	0	0.1
Emerging	0.7	0.8	1.0	0.7	0.2	0.5	-0.2	-0.1	-0.2	0	0.1
Alternatives											
Private equity	0.5	0.6	0.7	1.0	0.2	0	0	0.1	0.1	0	0.1
Property	0.4	0.3	0.2	0.2	1.0	0.1	0	0.3	0.3	0.1	0.1
Hedge funds	0.6	0.6	0.5	0	0.1	1.0	0.1	0.2	0.2	0.1	0.2
Commodities	-0.1	-0.1	-0.2	0	0	0.1	1.0	-0.1	-0.1	-0.1	-0.1
Bonds											
Corporate bonds	-0.1	-0.1	-0.1	0.1	0.3	0.2	-0.1	1.0	0.9	0.6	0.3
Gilts	-0.2	-0.2	-0.2	0.1	0.3	0.2	-0.1	0.9	1.0	0.7	0.5
Index linked gilts	0	0	0	0	0.1	0.1	-0.1	0.6	0.7	1.0	0.5
Cash	0.1	0.1	0.1	0.1	0.1	0.2	-0.1	0.3	0.5	0.5	1.0

Note: Correlation coefficients measure the degree to which two series move together. With a correlation coefficient of 1, the two series move in the same direction all the time. Negative correlation means the series move in opposite directions, whilst zero correlation suggests that there is a random relationship.

3. Overall recommendations for strategy changes

- 3.1. **Gilts & Bonds:** They consider that the level of bonds in the portfolio needs re-evaluation. Whilst bonds have performed well over the past 10 years, this level of performance cannot be expected to continue. There have been extended periods historically when bonds have given negative real returns (which has not been the case for equities) and bonds will be a more risky holding going forward:

‘Yields are currently very low when compared to historical levels. If inflation is in line with our forecast, real returns from bonds going forward will undoubtedly look poor compared to history. Consequently, even though the short term outlook for both growth and inflation is very uncertain, our inclination at the moment is to bias investment away from fixed income securities. The only environment in which real returns from conventional gilts are likely to match returns seen over the past two decades is if the global economy experiences a sustained period of Japanese style deflation and inflationary expectations fall dramatically. Even then, with nominal yields at 3.5%, the upside in the market is limited mathematically: a 1% fall in yields from current levels, for example, would mean an 8% rise in the price of the ten year bond. We would also note the shorter term problem with UK bonds. The Bank of England, through its quantitative easing programme, has been absorbing the bulk of new gilts issued by the UK Government to finance the huge increase in the fiscal deficit. As a result, it already owns close to 30% of the total gilt market. At some point, the Bank will have to stop its buying programme: if this is not accompanied by large cuts in government spending, there is likely to be a sharp sell-off in the gilt market and general rise in yields.’



Within bond investments, they consider that commercial bonds offer the best risk/return characteristics, stating that:

‘Corporate bond yields still look attractive relative to government bonds. The yield spread over government bonds has declined significantly but it is still above historical averages. Corporate bonds will always have a yield premium over government bonds to reflect the risk of default, which does mean that over the longer term at least they should outperform government bonds.’

3.2. **Equity benchmark:** They recommend a more global approach in the equity investment benchmark. This should improve diversification and investment opportunities in comparison with investment solely within to the UK. In some cases overseas investments may continue to grow whilst UK investments suffer losses, so increasing the range of options should reduce risk. They state:

‘Firstly, there are clear diversification benefits from investing on a global basis (international markets are correlated but they are not as highly correlated as bond markets); and secondly, there is a much larger “opportunity set” overseas (investing globally not only provides exposure to areas growing faster than the UK but also to sectors, such as technology, poorly represented in the UK). In addition, the UK market is very concentrated, with over 60% by market capitalisation in just twenty stocks. Why force yourself to invest in a UK listed company (say BP or Glaxo)

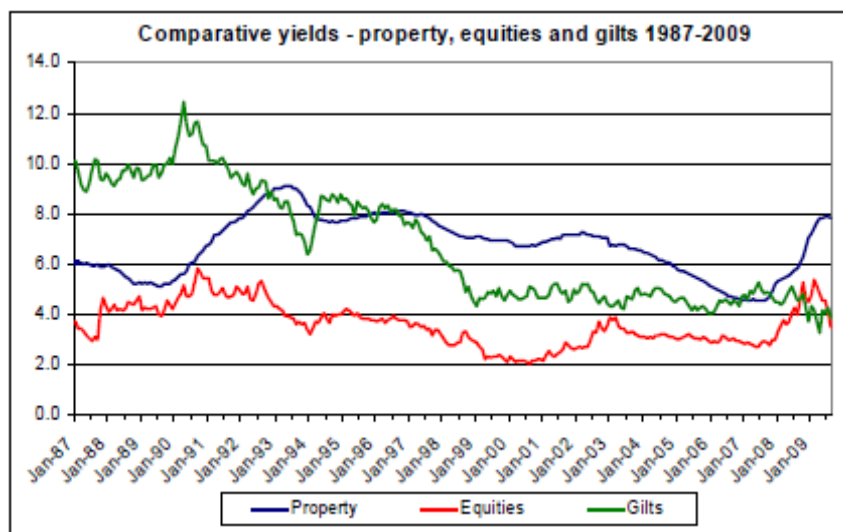
when it may be more sensible to invest in an overseas one (such as Exxon or Pfizer)? And what does it actually matter where a particular company is listed? It is either attractively valued relative to its peers or not. Our preference is for the global approach as we consider that this offers greater diversification and more opportunity for the fund manager to outperform.’

However, they also recognize the benefit of retaining an element of investment in the UK, indicating that:

‘The argument for “going global”, however, is not conclusive: with 50% of earnings coming from overseas and some 35% of dividends paid in US dollars, the UK market actually provides substantial international diversification by itself. Over short term periods, currency moves can also swamp the underlying differential in returns between the UK and overseas equity markets, as with bonds, which would suggest that one should still keep a substantial portion of equity exposure in the domestic market – or hedge out the currency risk. Thus, for FIG, we would suggest that the equity exposure in all portfolios be weighted towards global markets. However, we do not believe that there is a “right” answer to this question and do not feel strongly on this issue.’

3.3. **Diversification:** They considered the potential for inclusion of ‘alternative assets’ in the FIG portfolio. Alternative assets have grown in significance during the past 10 years, with regulation and greater availability of traded funds increasing access and liquidity and now have a place in many investment portfolios. However, the advisers concluded that in only commercial property was appropriate as a core holding for FIG funds, stating:

‘We believe the risk/return characteristics of commercial property, justify its inclusion in funds with a higher tolerance to risk and able to take a longer term view. Property is relatively illiquid but prices are currently very depressed (at a record level below their long term trend) and yields very attractive (in the UK they are more than double those of both gilts and equities).’



They also considered that whilst they should not be part benchmark, hedge fund and commodity investments should be permitted on an ad hoc basis for up to 10% of the Growth Fund and RPEF. This would allow managers access to additional opportunities and help to diversify holdings at times when other asset classes could be at risk.

- 3.4. **Currency:** The advisers considered the extent to which it is beneficial and practicable to invest in sterling or non-sterling denominated assets, and the extent to which non-sterling assets should be hedged to sterling. For equities, (provided non sterling exposure less than 60% of any fund) they considered hedging unnecessary. Underlying this is their view that on balance sterling is more likely to depreciate than appreciate against other currencies over time:

‘Currently, the vast bulk of assets are in sterling but we believe that a greater currency mismatch in the investment portfolios than at present could be justified: first, because, over the long term, sterling has tended to fall in value against most major currencies (not least because of its higher inflation rate) and there is no reason to suppose that this trend will not continue; second, because few of the fundamental factors that drive short to medium term currency movements appear to be in sterling’s favour. Among the fundamental factors, economic growth, inflation and interest rate differentials are not particularly significant at the moment but the UK does appear to have the worst fiscal and current account deficits among major economies.’

4. Investment Strategy – overview

The advisers provided an overview of their recommendations in the context of all available options, and their predicted ‘efficiency frontier’ (the red line in the figure below). This shows the maximum return available for any portfolio at any given level of volatility. The lowest volatility (and return) is delivered by cash and the maximum by private equity. The figure shows the overall repositioning of FIG investments (from current to proposed) which is modest in the context of the full range of possible investments.

Portfolios can also be compared using the Sharpe ratio. This ratio increases from 0.29 with the current strategy to 0.35 for the proposed, indicating greater value added for the volatility incurred with the proposed strategy.

Seven funds combined

