West Lindsey District Council
Making a Difference

GA.26 13/14	**E**
Governance & Audit Committee	
21 November 2013	

Subject: Proposed amendments to Investment Strategy

Report by:	Chief Finance Officer
Contact Officer:	Tracey Bircumshaw Group Accountant 01427 676542 Tracey.Bircumshaw@west-lindsey.gov.uk
Purpose / Summary:	To give consideration to the amendments to the Treasury Investment Strategy . These relate to current counterparty limits, and additions to the specified and non- specified investments. It is anticipated that such work should improve yields within managed risks to security and liquidity.

RECOMMENDATIONS:

1. **That Members incorporate the recommended changes, and alternative investments, detailed below, into the Investment Strategy and in addition include the limitations as contained within the report, ensuring risk mitigation and compliance with the requirements of the Treasury Management Code of Practice:**

   - **Increase the maximum amount invested above 1 year to £6m**
   - **Inclusion of Enhanced Money Market Funds**
   - **Inclusion of Local Authority Property Asset Fund**
   - **Inclusion of Corporate Bonds Fund**

2. **That Members recommend to Council the amendments to the Investment Strategy 2013/14 and in addition these amendments be incorporated into the draft Treasury Management Strategy 2014/15 being presented to this Committee in January for consideration.**

IMPLICATIONS

Legal:

The Local Government and Finance Act 2003 and the Treasury Management Code of Practice and Sectorial Guidance include a key principal that an organisations appetite for risk is included in their annual Treasury Management Strategy and this should include any use of financial instruments for the prudent management of those risks, and should ensure that priority is given to security and liquidity when investing.

Financial: FIN/46/14

The proposed changes to the Investment Strategy will enable the Finance Team to invest in a wider portfolio of investments. The aim of this will be to achieve improved rates of returns, albeit at higher risk.

Additional administrative/management costs will be incurred to facilitate investments, generally as a % of dealing price or annual investments.

It must be noted that there is a level of risk with all investments, past performance is no guarantee of future returns. Investment values and yields can fall as well as rise.

Should the Local Authority Property Asset Fund be utilised, the investments may be treated as Available For Sale Financial Assets thus only reflecting capital growth/loss upon sale or redemption. The spread of initial investment and sale price is high at 7%, therefore this investment should be considered long term greater than >3 years to achieve a suitable return, dependent on the market. In essence this investment would possibly need to be held in excess of 5 years.

The draft Treasury Management Strategy will be presented to this Committee in January for scrutiny and will include the recommendations of this meeting.

Staffing :

None arising from this report.

Equality and Diversity including Human Rights :

*NB: A full impact assessment **HAS TO BE** attached if the report relates to any new or revised policy or revision to service delivery/introduction of new services.*

Risk Assessment :

Interest Rate Risk: A rise in interest rates may lead to capital investment loss due to the inverse price and yield relationship and vice versa.

Inflation Risk: Real returns can be eroded if inflation is expected to or rises during the term of the investment, therefore capital value may be reduced

Re-Investment Risk: the effect of changing interest rates on re-investment before maturity.

Credit Risk: The value of an investment can be affected by the credit quality/rating of the issuer.

Default Risk: Possibility that total principal may not be returned before maturity, or partially returned.

Risks associated with investing for longer periods, and in instruments where the values can go down as well as up, will require mitigation as there will be increased risk to the security and liquidity of investments.

Mitigation of these risks will be undertaken by defining the restrictions of time and maximum value of investment made and with appropriate financial appraisals being undertaken for each investment. Close monitoring of the investment performance will also be undertaken.

By putting these mitigations in place will result in a spread of risk throughout the portfolio.

Climate Related Risks and Opportunities :

None arising from this report.

Title and Location of any Background Papers used in the preparation of this report:

Treasury Management Code of Practice and Cross-Sectorial Guidance Notes 2011

All papers are located in the Financial Services section, Guildhall

Call in and Urgency:

Is the decision one which Rule 14 of the Scrutiny Procedure Rules apply?

Yes		**No**	**x**

Key Decision:

Yes		**No**	**x**

1. Background

The Council approved the 2013/14 Investment Strategy as part of the overall Treasury Management Strategy on 4 March 2013. The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, then return.

Since 2010/11 the Council has been very risk averse, operating in the very low risk investments specifically cash investments in Money Market Funds and fixed term deposits, shorter than 1 year, with Government guaranteed UK banks. The prevailing economic conditions are expected continue over the medium term, and therefore the Council is now considering alternative investments that meet the overarching principles of security of capital, liquidity and yeild.

Our current portfolio of investments include;

> Money Market Funds AAA rated - these funds are highly liquid and money can be redeemed on a daily basis. We invest in the large value funds which ensures that any risks are spread over the various types of investments the fund holds. Interest rates are currently at an all time low at circa 0.32%.
>
> UK Banks – Government Guaranteed – Fixed rate deposits
> Interest rates for 3 months 0.7%, at 12 months 0.98%
>
> Nationwide Building Society - Fixed rate deposits ranging from 3 months to 1 year again rates remain low with 3 months deposits giving a return of 0.5% and 1 year 0.7%

Our recent benchmarking data can be found at Appendix A which reflects that like us, other authorities are working within low risk portfolio's.

Whilst our Investment Strategy and Counterparty list also includes a variety of other alternatives, we have, operationally only made use of the above, due to their low risk and high liquidity, in addition all other banks within our rating criteria are international banks.

With the aim of increasing investment returns whilst still ensuring the security of capital and maintaining adequate liquidity levels, it is appropriate that members discuss their appetite for risk, and consider amendments to the Investment Strategy.

2. Executive Summary

There are 3 ways in which to improve returns, however, each carry a higher element of risk than that currently being operationally undertaken.

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Increase length and/or value of allowable fixed term investments.

Our current strategy limits investment in excess of 1 year at £2m

Reduce the counterparty criteria, allowing investment in lower rated investments.

The minimum rating criteria is currently F1 (Fitch)

Increase the variety of Specified and Non-Specified investments

Increase allowable investment types and operationally diversify the portfolio of investments therefore mitigating risks over the whole portfolio.

3. Increase the allowable amount of investments over 1 year.

Consideration of increasing the total allowable investments over 1 year from £2m to a £6m and to a maximum of 25% of the estimated average investments as detailed in the annual Treasury Management Strategy.

By imposing a maximum % as well as a maximum investment amount will mitigate potential liquidity issues in the medium term.

Current forecasts project that this proposal is sustainable over the Medium Term Financial Plan. However, any deviation from the MTFP may result in short term borrowing being required should the cash flow require it.

4. Reduce the counterparty criteria

It is not proposed to reduce the counterparty criteria.

5. Specified and Non-Specified Investments

In deciding which types of investment to use the Council has regard to its treasury management advisors. Capita Asset Services (previously Sector) have been consulted with regard to alternative investment opportunities.

Our current approved listing of Specified and Non-Specified Investments are detailed below;

Specified Investments – These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the Council has the right to be repaid within 12 months if it wishes. These are considered low risk assets where the possibility of loss of principal or investment income is small. These would include sterling investments that would not be defined as capital expenditure with:

	Specified Investment Category	Limit Per Counterparty (£ or %)	Current Yield %
	The UK Government Debt Management Account deposit facility UK Treasury Bills, UK Guaranteed Bonds Gilts with less than one year to maturity.	No limit/6 mths	0.30%
	Supranational bonds of less than one year's duration.	£5m/1 year	N/A
	Other local authorities, parish council or community council.	£5m/5 year	1.5% (5 Yrs)
	Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency. For category 4 this covers pooled investment vehicles, such as money market funds, rated AAA by Standard and Poor's, Moody's or Fitch rating agencies.	£5m per counter party/overnight	0.38%

Non-Specified Investments – Non-specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non-specified investments would include any sterling investments with:

	Non Specified Investment Category	Limit (£ or %)	Current Yield%
	Gilt edged securities with a maturity of greater than one year. These are Government bonds and so provide the highest security of interest and the repayment of principal on maturity. The value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	£5m/5 years	1.25%
	The Council's own banker if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.	£250,000/1 day	0%
	Any **bank or building society** that has a minimum long term credit rating of AA, for		

	deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).	£2m/5 years	

Attached at Appendix B is a recent paper produced by our Treasury Advisors, Capita, which gives a basic overview of Alternative Investments.

As an addition to the above, the following investment vehicles are recommended for consideration;

Pooled Investment Vehicles

a) **Enhanced money market funds** – are pooled investment vehicles, targeting the longer term horizon, there is an enhanced yield opportunity, investment would be for at least 3 months. Each enhanced money market fund is made up of a variety of alternative asset classes (high quality, short term securities i.e. floating rate notes, commercial bonds, asset backed securities, certificates of deposit, bonds etc). Therefore spreading risks and improving liquidity.

It is important to ensure an understanding of the Fund's objectives and that these align with our own investment priorities, therefore any funds utilised would be appropriately researched. Any enhanced yield will be derived through lengthening investments (duration), so if market yields rise these products may post a loss or fall in value. These are a longer term hold (6 months or more, ideally longer).

Typical rates are currently AAA rated 0.83%, AA rated 1.03%,

Proposal to included within Specified Investments and Non-specified investments. Minimum criteria AA rated. Maximum Investment £2m per counterparty. Maximum term 5 years.

b) **CCLA Local Authority Property Funds –** longer-term investment opportunity 5+ years, designed to achieve a combination of capital growth and income growth from investments in the commercial property sector. The portfolio is actively managed and seeks to boost returns by lease and tenant management and property improvement.

Strong governance arrangements are in place with the Trustee being the Local Authorities Mutual Investment Trust (LAMIT) which is controlled by representations from the Local Government Association (LGA), Scottish and Northern Ireland LG Officers Associations, who approve investment strategy and risk profile of the portfolio and reviews performance.

Security of capital cannot be guaranteed as both property values and rental markets can fluctuate.

The spread between purchase of a CCLA investment and redeeming is quite high (7%), so there is an immediate loss on purchase. However, the CCLA try to match sellers with buyers to avoid this cost.

As property assets take time to be liquidated, redemptions may not be readily realisable; a period of notice not exceeding six months may be imposed for the redemption of units. As such these funds are highly illiquid.

Dividends would be treated as revenue income, however, the General Fund is protected from fluctuations in the unit price. The investment would be treated as an available for sale financial asset. (Subject to Audit agreement)

Yield declared at 30 September 2013 was 2.78%
Charges 0.65% annually.
Minimum investment £25,000, subsequent investments minimum £10,000

Proposal: To include in Non-Specified Investments. Maximum investment £2m. Maximum term 10 Years.

Corporate Bond Funds

These funds are pooled investment vehicles which invest in corporate and government-level bonds. The investor buys units in the fund which are redeemable at a Net Asset Value (NAV)

Minimum investments may apply ie £1m

The funds are actively managed and therefore charges apply, which include commission and management fees.

Recent rates achieved 1 year 3.43% (8.99% 5 year annualised)

Proposal: To include in Specified and Non-Specified Investments. Maximum investment £1m per counterparty, Maximum Investment £2m. Maximum term 5 years.

6. Risks

Risks with Non-Specified Investments
In deciding which type of non-specified investment instruments to use the reasons and associated risks were assessed and are detailed below:

Investment Type	Why use it	Associated Risk
Fixed deposits with credit rated deposit takers (banks and building societies) with maturities greater than 1 year	Certainty of rate of return over period invested which aids forward planning. No movement in capital value of deposit despite changes in interest rate environment.	Credit risk: potential for default and potential for greater deterioration in credit quality over longer period. Illiquid: cannot be traded or repaid prior to maturity. Return will not increase if interest rates rise after making the investment.
Fixed deposits with UK local authorities with maturities greater than 1 year	High credit quality. Certainty of rate of return over period invested which aids forward planning. No movement in capital value of deposit despite changes in interest rate environment	Illiquid: cannot be traded or repaid prior to maturity. Return will not increase if interest rates rise after making the investment. Returns are lower than comparative investments with banks and building societies
Government Guaranteed Bonds – with banks and building societies under the government's guarantee scheme.	Liquid, unlike fixed deposits which are illiquid. Very secure asset class (similar to gilts). If traded, potential for capital gain through appreciation in value (i.e. sold before maturity).	'Market or interest rate risk': Yield subject to movement during life of bond which could negatively impact on price of the bond. The price of these bonds is more volatile than gilts.
Gilts (UK sovereign bonds). Custodial arrangement required prior to purchase	Liquid, unlike fixed deposits. Most secure asset class. If traded, potential for capital gain through appreciation in value (i.e. sold before maturity). No loss of capital investment if held to maturity.	'Market or interest rate risk': Yield subject to movement during life of bond which could negatively impact on price of the bond.
Local Authority Bonds Custodial arrangement required prior to purchase	If held to maturity, known yield (rate of return) per annum, which would be higher than that on comparable gilt. Aids forward planning. High credit quality	Scarcity of supply. 'Market or interest rate risk': Yield subject to movement during life of bond which could negatively impact on price of the bond. Less liquid than gilts.
Supranational Bonds Custodial arrangement required prior to purchase	Excellent credit quality. Relatively liquid (not as liquid as gilts). If held to maturity, known yield (rate of return) per annum, which would be higher than that on comparable gilt. Aids forward planning. If traded, potential for capital gain through appreciation in value (i.e. sold before maturity).	'Market or interest rate risk': Yield subject to movement during life of bond which could negatively impact on price of the bond i.e. potential for capital loss. The price of these bonds is more volatile than gilts.
Enhanced Money Market Funds	Longer term investments with minimum 7 day liquidity. A variety of high quality asset classes are held within the fund, thus reducing security risk.	'Market or interest rate risk': Yield subject to movement during life of bond which could negatively impact on price of the bond. Fund objectives may not meet our own requirements.
Local Authority Property Assets Fund	Longer term investment	Potential for capital loss (or capital gain).

	Capital secured against tangible assets. Yields currently higher than those achievable from other investments. Appropriate Governance Arrangements in place and overseen by LGA.	Iliquid , 6 month notice period for redemption and this may be higher if assets have to be sold to return investment.
Corporate Bond Funds	Managed by experienced fund managers therefore benefitting from economies of scale, diversification of portfolio. Longer term investment vehicle	Market or interest rate risk': Yield subject to movement during life of bond which could negatively impact on price of the bond. Fund objectives may not meet our own requirements.

CAPITA

Asset Services

West Lindsey District Council

Investment Portfolio Benchmarking Analysis

September 2013

Group Members:

City Of Lincoln Council

Doncaster Metropolitan Borough Council

Hambleton District Council

Melton Borough Council

North Kesteven District Council

Police And Crime Commissioner For Lincolnshire

Selby District Council

South Kesteven District Council

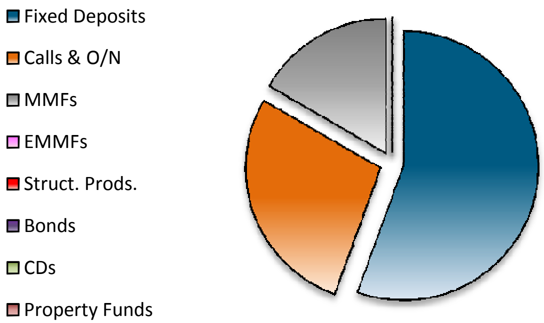
West Lindsey District Council

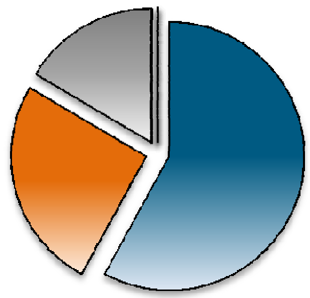
West Lindsey District Council

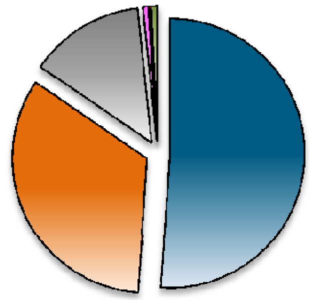
Summary Sheet

	West Lindsey District Council	Benchmarking Group 11 (9)	Non-Met Districts (70)
		Basic Portfolio Characteristics	
WARoR	0.73%	0.92%	0.78%
WAM	82	121	87
WATT	136	231	169
WA Credit Risk	3.5	3.4	3.4
Model WARoR	0.70%	0.83%	0.77%
Difference	0.02%	0.09%	0.01%
Model Band	0.59% - 0.81%	0.72% - 0.94%	0.66% - 0.88%
Performance	Inline	Inline	Inline

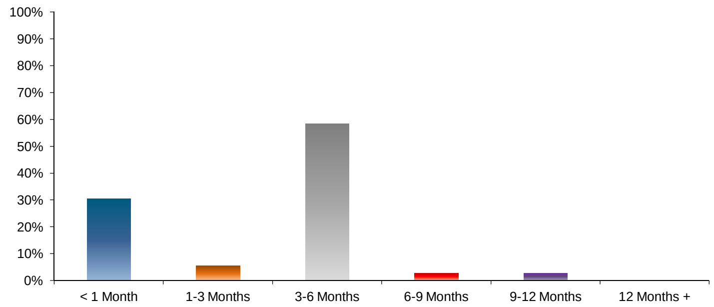
Asset Breakdown

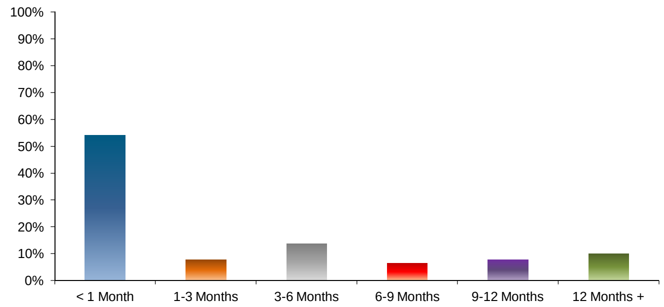


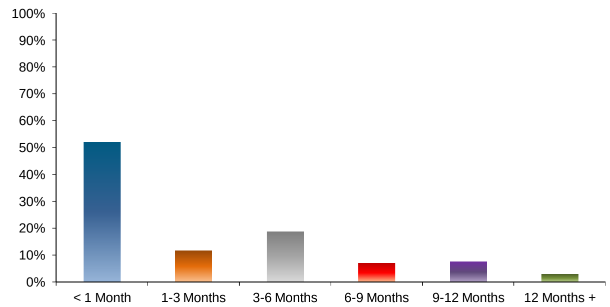




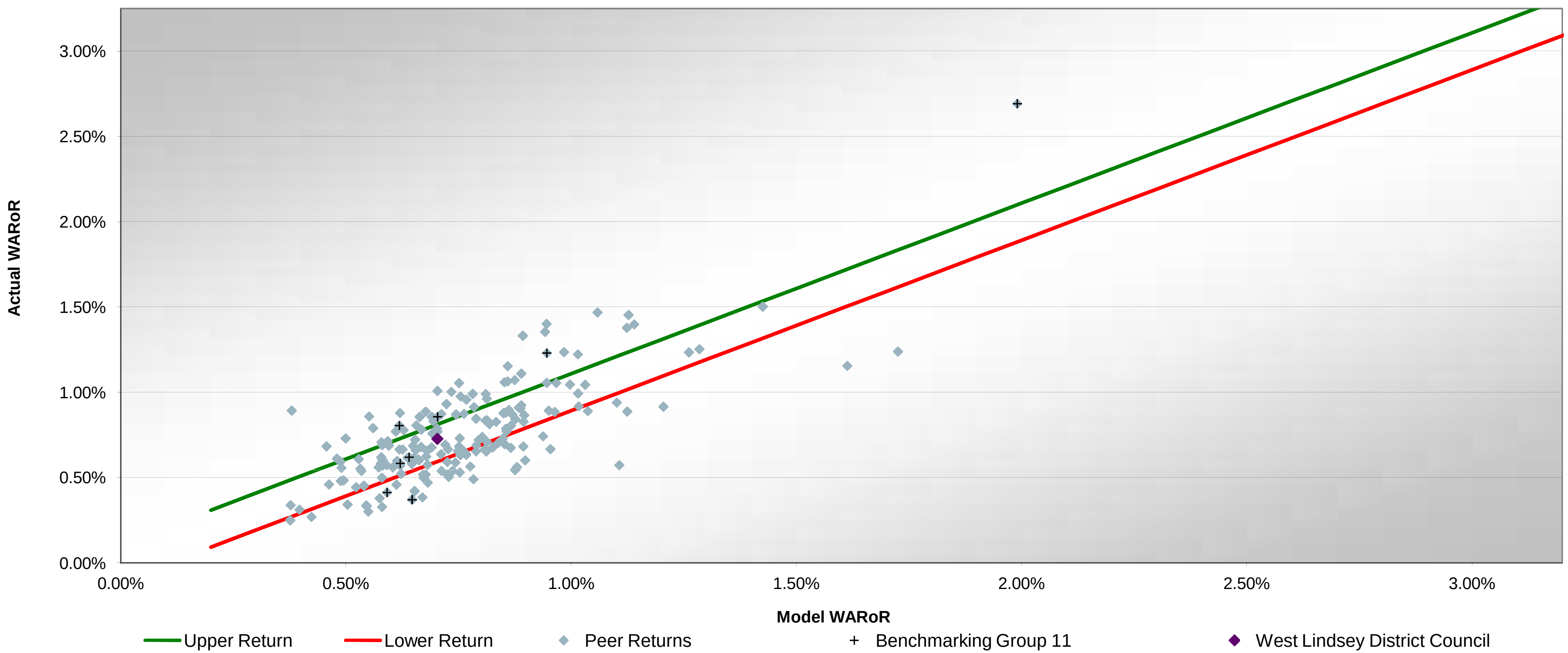
Maturity Profiles







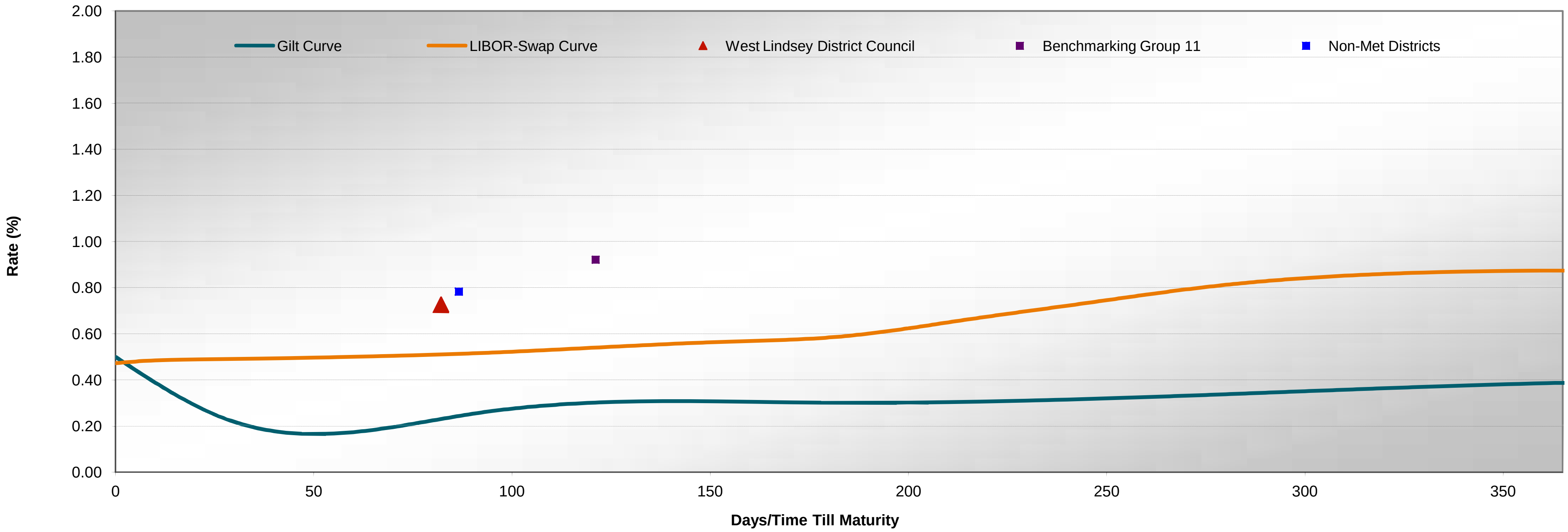
Population Returns against Model Returns



	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
West Lindsey District Council	0.73%	0.70%	0.02%	0.59%	0.81%	Inline

West Lindsey District Council

Returns Comparable Against the Risk-Free Rate and LIBOR Curve



	WARoR	WAM	WATT	WARisk	Gilt	LIBOR-Swap	Difference Gilt	Difference LIBOR-Swap	Model Bands	Performance
West Lindsey District Council	0.73%	82	136	3.5	0.23%	0.51%	0.50%	0.22%	0.59% - 0.81%	Inline
Benchmarking Group 11	0.92%	121	231	3.4	0.30%	0.54%	0.62%	0.38%	0.72% - 0.94%	Inline
Non-Met Districts	0.78%	87	169	3.4	0.25%	0.51%	0.54%	0.27%	0.66% - 0.88%	Inline

West Lindsey District Council

Peer Comparison

	West Lindsey District Council	Benchmarking Group 11 (9)		Non-Met Districts (70)		Population Average (184)	
Basic Characteristics							
Principal	£18,000,000	£23,002,681		£26,208,115		£74,708,967	
WARoR	0.73%	0.92%		0.78%		0.76%	
WAM	82	121		87		85	
WATT	136	231		169		173	
WA Credit Risk	3.50	3.38		3.44		3.21	
Portfolio Breakdown							
Fixed Deposits	55.56%	57.94%	9	51.08%	67	52.81%	173
Calls & O/N	27.78%	25.59%	8	33.41%	64	32.86%	168
MMFs	16.67%	16.47%	5	13.84%	44	11.59%	107
EMMFs	0.00%	0.00%	0	0.65%	3	0.46%	7
Struct. Prods.	0.00%	0.00%	0	0.25%	2	0.49%	8
Bonds	0.00%	0.00%	0	0.00%	0	0.88%	7
CDs	0.00%	0.00%	0	0.76%	8	0.91%	17
Property Funds	0.00%	0.00%	0	0.00%	0	0.00%	0
Institution Breakdown							
Banks	55.56%	62.71%	9	68.95%	70	69.23%	182
Building Socs.	27.78%	12.96%	4	10.91%	38	7.20%	97
Government	0.00%	7.85%	3	5.65%	18	11.47%	66
MMFs	16.67%	16.47%	5	13.84%	44	11.59%	107
EMMFs	0.00%	0.00%	0	0.65%	3	0.46%	7
MLDBs	0.00%	0.00%	0	0.00%	0	0.00%	0
Other	0.00%	0.00%	0	0.00%	0	0.04%	3
Domestic/Foreign Exposure							
Domestic	83.33%	80.15%	9	81.86%	70	81.90%	184
Foreign	0.00%	3.38%	2	3.64%	20	6.05%	55
MMFs	16.67%	16.47%	5	13.84%	44	11.59%	107
EMMFs	0.00%	0.00%	0	0.65%	3	0.46%	7
Maturity Structure							
< 1 Month	30.56%	54.23%		52.14%		51.39%	
1-3 Months	5.56%	7.71%		11.72%		13.11%	
3-6 Months	58.33%	13.74%		18.73%		18.58%	
6-9 Months	2.78%	6.55%		6.94%		7.38%	
9-12 Months	2.78%	7.71%		7.54%		7.31%	
12 Months +	0.00%	10.06%		2.93%		2.24%	

West Lindsey District Council

Detailed Peer Comparison

	West Lindsey District Council					Benchmarking Group 11 (9)						Non-Met Districts (70)				
	%	WARoR	WAM	WATT		%	WARoR	WAM	WATT	n		%	WARoR	WAM	WATT	n
Asset Breakdown																
Fixed Deposits	55.56%	0.72%	100	197		57.94%	1.12%	184	356	9		51.08%	0.93%	143	284	67
Calls	27.78%	0.95%	95	95		25.59%	0.52%	16	16	8		33.41%	0.57%	18	18	64
Overnight	0.00%	0.00%	0	0		0.00%	0.00%	0	0	0		0.00%	0.00%	0	0	0
MMFs	16.67%	0.39%	0	0		16.47%	0.21%	0	0	5		13.84%	0.24%	0	0	44
EMMFs	0.00%	0.00%	0	0		0.00%	0.00%	0	0	0		0.65%	0.03%	0	0	3
Structured Prods.	0.00%	0.00%	0	0		0.00%	0.00%	0	0	0		0.25%	0.05%	9	26	2
Cert.of Deposit	0.00%	0.00%	0	0		0.00%	0.00%	0	0	0		0.76%	0.06%	9	19	8
Gov. Bonds	0.00%	0.00%	0	0		0.00%	0.00%	0	0	0		0.00%	0.00%	0	0	0
Corp. Bonds	0.00%	0.00%	0	0		0.00%	0.00%	0	0	0		0.00%	0.00%	0	0	0
MLDB Bonds	0.00%	0.00%	0	0		0.00%	0.00%	0	0	0		0.00%	0.00%	0	0	0
Property Funds	0.00%	0.00%	0	0		0.00%	0.00%	0	0	0		0.00%	0.00%	0	0	0
Institutional Breakdown																
Banks	55.56%	0.94%	93	152		62.71%	1.19%	139	299	9		68.95%	0.92%	98	195	70
Building Socs.	27.78%	0.50%	109	184		12.96%	0.40%	55	120	4		10.91%	0.32%	49	108	38
Government	0.00%	0.00%	0	0		7.85%	0.17%	59	103	3		5.65%	0.14%	49	82	18
MMFs	16.67%	0.39%	0	0		16.47%	0.21%	0	0	5		13.84%	0.24%	0	0	44
EMMFs	0.00%	0.00%	0	0		0.00%	0.00%	0	0	0		0.65%	0.03%	0	0	3
MLDBs	0.00%	0.00%	0	0		0.00%	0.00%	0	0	0		0.00%	0.00%	0	0	0
Other	0.00%	0.00%	0	0		0.00%	0.00%	0	0	0		0.00%	0.00%	0	0	0
Foreign Breakdown																
Domestic	83.33%	0.80%	98	163		80.15%	1.01%	145	278	9		81.86%	0.86%	104	200	70
Foreign	0.00%	0.00%	0	0		3.38%	0.11%	2	10	2		3.64%	0.78%	9	16	20
MMF	16.67%	0.39%	0	0		16.47%	0.21%	0	0	5		13.84%	0.24%	0	0	44
EMMFs	0.00%	0.00%	0	0		0.00%	0.00%	0	0	0		0.65%	0.03%	0	0	3
Sovereign State Breakdown																
UK	83.33%	0.80%	98	163	**UK**	80.15%	1.01%	145	278	9	**UK**	81.86%	0.86%	104	200	70
					SWE	1.69%	0.07%	0	0	1	**SWE**	2.50%	0.14%	9	12	17
					SAU	0.68%	0.04%	2	3	1	**SING**	0.55%	0.03%	4	9	5
					UAE	0.68%	0.06%	1	20	1	**UAE**	0.29%	0.02%	1	5	2
					SING	0.34%	0.03%	3	3	1	**AUS**	0.19%	0.01%	0	1	1
											SAU	0.09%	0.00%	0	0	1
											FIN	0.02%	0.01%	0	3	1
Sovereign Rating Breakdown																
AA+	83.33%				**AA+**	80.15%					**AA+**	81.86%				
					AAA	2.03%					**AAA**	3.27%				
					AA	0.68%					**AA**	0.29%				
					AA-	0.68%					**AA-**	0.09%				

Since MMFs are ring-fenced institutions and do not belong to a specific country, the sovereign breakdowns will exclude them from the analysis. As a result the "% of Portfolio" may not add up to 100%.

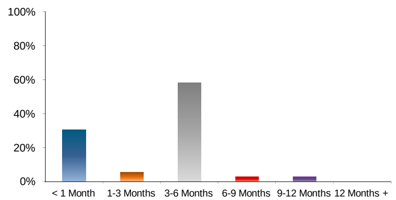
West Lindsey District Council

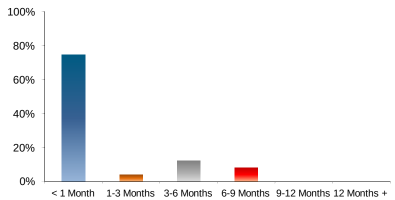
Selected Peer Comparison

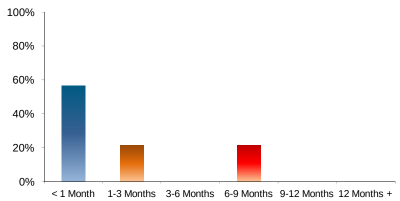
	West Lindsey District Council	City Of Lincoln Council	Doncaster Metropolitan Borough Council	Hambleton District Council
Basic Portfolio Characteristics				
WARoR	0.73%	0.58%	0.62%	0.80%
WAM	82	37	47	196
WATT	136	88	93	229
WA Credit Risk	3.5	2.6	3.0	3.3
Model WARoR	0.70%	0.62%	0.64%	0.62%
Difference	0.02%	-0.04%	-0.02%	0.19%
Model Band	0.59% - 0.81%	0.51% - 0.73%	0.53% - 0.75%	0.51% - 0.73%
Performance	Inline	Inline	Inline	Above

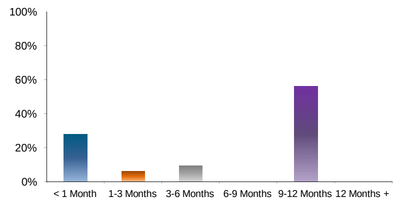
Portfolio Breakdown	%	WARoR	WAM	WATT	%	WARoR	WAM	WATT	%	WARoR	WAM	WATT	%	WARoR	WAM	WATT
Fixed Deposits	55.56%	0.72%	100	197	33.43%	0.77%	86	240	43.29%	0.78%	109	215	72.15%	0.92%	271	317
Calls	27.78%	0.95%	95	95	20.89%	0.62%	38	38	56.71%	0.50%	0	0	27.85%	0.50%	0	0
Overnight	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
MMFs	16.67%	0.39%	0	0	45.68%	0.43%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
EMMFs	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Structured Prods.	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Cert.of Deposit	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Gov. Bonds	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Corp. Bonds	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
MLDB Bonds	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Property Funds	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Institution Breakdown																
Banks	55.56%	0.94%	93	152	45.96%	0.75%	78	158	100.00%	0.62%	47	93	100.00%	0.80%	196	229
Building Socs.	27.78%	0.50%	109	184	8.36%	0.54%	9	183	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Government	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
MMFs	16.67%	0.39%	0	0	45.68%	0.43%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
EMMFs	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
MLDBs	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Other	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Domestic/Foreign Exposure																
Domestic	83.33%	0.80%	98	163	54.32%	0.71%	68	162	100.00%	0.62%	47	93	100.00%	0.80%	196	229
Foreign	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0

Maturity Profiles









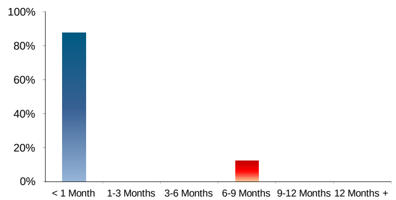
West Lindsey District Council

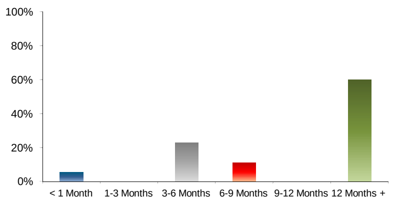
Selected Peer Comparison

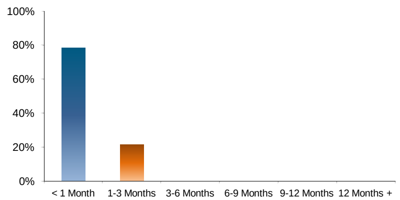
	Melton Borough Council	North Kesteven District Council	Police And Crime Commissioner For Lincolnshire	Selby District Council
Basic Portfolio Characteristics				
WARoR	0.37%	2.69%	0.41%	1.23%
WAM	34	409	13	169
WATT	67	884	35	373
WA Credit Risk	3.3	6.3	2.9	2.4
Model WARoR	0.65%	1.99%	0.59%	0.95%
Difference	-0.28%	0.70%	-0.18%	0.28%
Model Band	0.54% - 0.76%	1.88% - 2.10%	0.48% - 0.70%	0.84% - 1.05%
Performance	Below	Above	Below	Above

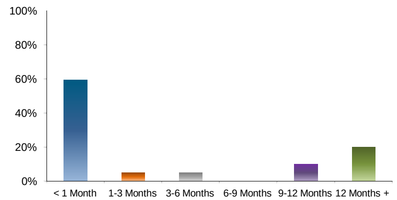
	Melton Borough Council				North Kesteven District Council				Police And Crime Commissioner For Lincolnshire				Selby District Council			
Portfolio Breakdown	%	WARoR	WAM	WATT	%	WARoR	WAM	WATT	%	WARoR	WAM	WATT	%	WARoR	WAM	WATT
Fixed Deposits	63.41%	0.39%	53	106	99.96%	2.69%	410	884	64.41%	0.40%	20	54	55.70%	1.81%	298	663
Calls	0.00%	0.00%	0	0	0.04%	0.50%	0	0	35.59%	0.44%	0	0	25.32%	0.58%	12	12
Overnight	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
MMFs	36.59%	0.33%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	18.99%	0.39%	0	0
EMMFs	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Structured Prods.	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Cert.of Deposit	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Gov. Bonds	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Corp. Bonds	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
MLDB Bonds	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Property Funds	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Institution Breakdown																
Banks	51.83%	0.41%	61	124	28.60%	4.03%	543	1378	57.06%	0.54%	14	35	55.70%	1.60%	69	271
Building Socs.	9.15%	0.37%	21	28	71.40%	2.16%	356	686	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Government	2.44%	0.25%	7	18	0.00%	0.00%	0	0	42.94%	0.25%	12	35	25.32%	1.06%	516	876
MMFs	36.59%	0.33%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	18.99%	0.39%	0	0
EMMFs	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
MLDBs	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Other	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0	0.00%	0.00%	0	0
Domestic/Foreign Exposure																
Domestic	48.17%	0.39%	65	111	100.00%	2.69%	409	884	100.00%	0.41%	13	35	65.82%	1.62%	257	566
Foreign	15.24%	0.40%	16	90	0.00%	0.00%	0	0	0.00%	0.00%	0	0	15.19%	0.60%	0	0

Maturity Profiles









West Lindsey District Council

Selected Peer Comparison

Basic Portfolio Characteristics

	South Kesteven District Council
WARoR	0.86%
WAM	103
WATT	178
WA Credit Risk	3.2
Model WARoR	0.70%
Difference	0.15%
Model Band	0.59% - 0.81%
Performance	Above

Portfolio Breakdown

	%	WARoR	WAM	WATT	%	WARoR	WAM	WATT	%	WARoR	WAM	WATT	%	WARoR	WAM	WATT
Fixed Deposits	33.55%	1.56%	307	530												
Calls	36.13%	0.61%	0	0												
Overnight	0.00%	0.00%	0	0												
MMFs	30.33%	0.37%	0	0												
EMMFs	0.00%	0.00%	0	0												
Structured Prods.	0.00%	0.00%	0	0												
Cert.of Deposit	0.00%	0.00%	0	0												
Gov. Bonds	0.00%	0.00%	0	0												
Corp. Bonds	0.00%	0.00%	0	0												
MLDB Bonds	0.00%	0.00%	0	0												
Property Funds	0.00%	0.00%	0	0												

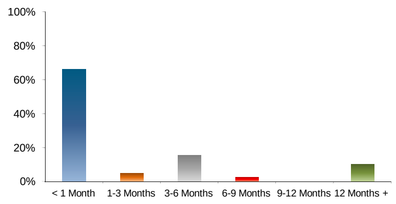
Institution Breakdown

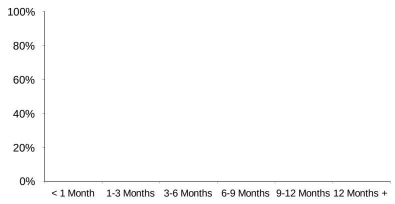
	%	WARoR	WAM	WATT
Banks	69.67%	1.07%	148	255
Building Socs.	0.00%	0.00%	0	0
Government	0.00%	0.00%	0	0
MMFs	30.33%	0.37%	0	0
EMMFs	0.00%	0.00%	0	0
MLDBs	0.00%	0.00%	0	0
Other	0.00%	0.00%	0	0

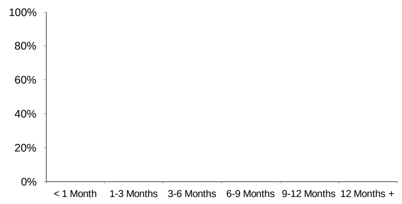
Domestic/Foreign Exposure

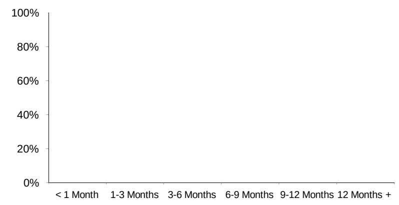
	%	WARoR	WAM	WATT
Domestic	69.67%	1.07%	148	255
Foreign	0.00%	0.00%	0	0

Maturity Profiles









Benchmarking Rationale and Methodology

The aim of this benchmarking model is to compare portfolio weighted average rate of returns (WARoR) by adjusting for the risks inherent in the portfolio. The main risks in cash portfolios are:

Maturity Risk
Credit Risk

As such, the model must normalise WARoRs by adjusting for these risks so as to calculate risk-adjusted returns, or "Model WARoR". The risks the model looks at include:

Maturity Risk
Credit Risk
Change in the shape of the yield curve

This will account for the majority of all risk in the portfolio, however, there will still be some "model uncertainty" as no model can fully explain each WARoR. The difference in model WARoR and actual WARoR may be due to the following reasons:

Timing differences
Higher diversification
Tilt towards a particular asset type or institution type that is extraordinarily paying an above market rate (e.g. special tranche rates)

As a result, the model will build "Standard Error Bands" around the model WARoR calculated so as to adjust for this model uncertainty. This gives us a range for where the actual WARoR should fall. If the actual WARoR is above this upper band, then we would say the client is above on a risk-adjusted basis given the risks inherent in the portfolio. If the actual WARoR is below the lower band, then we would say the client is below on a risk-adjusted basis given the risks inherent in the portfolio.

Model Band — Some values when compared to the Model Band will fall outside the range even if the value appears to be equal to the minimum or maximum. This is due to rounding the data to two decimal places within Excel.

For example:
The value returned is 0.9512 and the range is 0.9541 – 1.2321. When rounded the data will be represented as 0.95 and a range of 0.95 – 1.23, although this appears to be in line with the range the underlying data will actually fall outside.

Definitions

WARoR	Weighted Average Rate of Return	This is the average annualised rate of return weighted by the principal amount in each rate.
WAM	Weighted Average Time to Maturity	This is the average time, in days, till the portfolio matures, weighted by principal amount.
WATT	Weighted Average Total Time	This is the average time, in days, that deposits are lent out for, weighted by principal amount.
WA Risk	Weighted Average Credit Risk Number	Each institution is assigned a colour corresponding to a suggested duration using Capita Asset Services' Suggested Credit Methodology. 1 = Yellow; 1.25 = Pink 1; 1.5 = Pink 2, 2 = Purple; 3 = Blue; 4 = Orange; 5 = Red; 6 = Green; 7 = No Colour
Model WARoR	Model Weighted Average Rate of Return	This is the WARoR that the model produces by taking into account the risks inherent in the portfolio.
Difference	Difference	This is the difference between the actual WARoR and the model WARoR; Actual WARoR minus Model WARoR

CAPITA

Asset Services

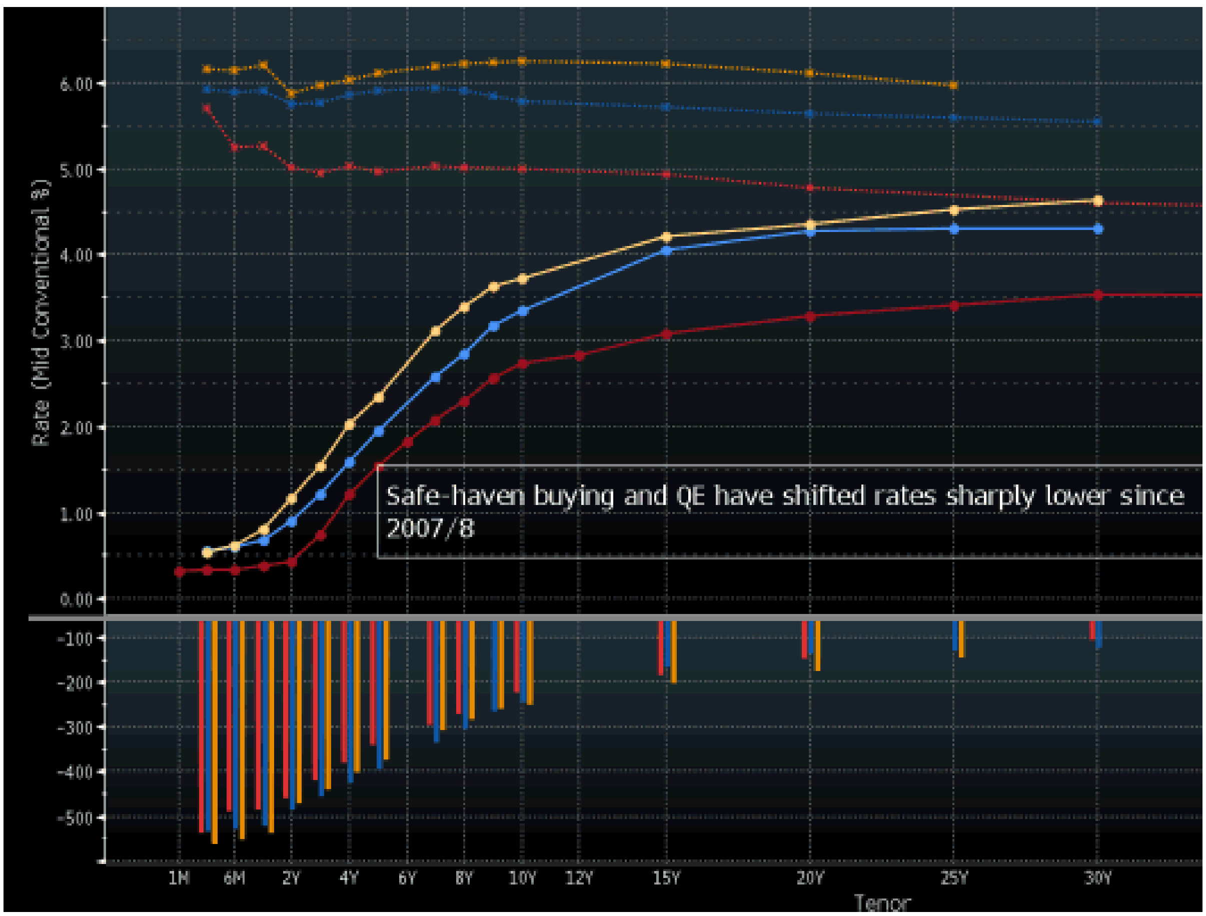
Capita Asset Services

Basics of Alternative Investments, October 2013

1. Introduction

Since the onset of the financial crisis money market rates have fallen drastically, in line with government and corporate bond yields. Yields have been squeezed even lower during the global financial crisis of 2008 and the European debt crisis, generating safe haven buying of UK government debt. Additionally, the Bank of England's monetary policy measure of pumping liquidity into the economy through quantitative easing (government bond purchases) has pushed yields lower, by design. As shown in *figure 1*, yield curves look unrecognisable from five years ago, and the ultra record low yields are reflected in most risk averse local authority portfolios.

Figure 1 – Sovereign yield curve against Corporate Bond Yields since Oct 2007



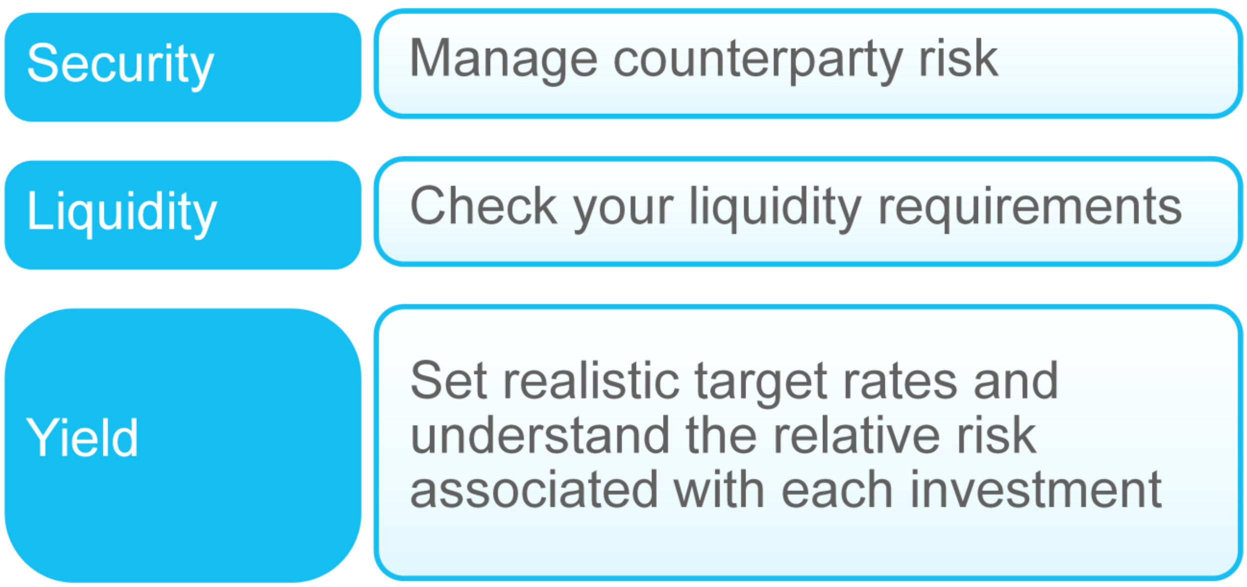
Key: UK Sovereign Curve – Red, GBP Euro AA Bank/Financial Bond Curve – Blue/Yellow (Lighter shades are the respective curve in 2007)

Even achieving an enhancement on returns over conventional investments is quite difficult in the current market conditions, without increasing duration of investments and/or reducing counterparty rating criteria.

An alternative route, to find additional counterparties or to help diversify the portfolio, would be to allocate a proportion of the portfolio to funds or direct exposure that focus on either property or fixed income securities. As well as direct investments in alternatives, there is merit in investing in funds for the medium to long end time horizon.

Whether it is the conventional investment type or alternative, (in the order of) Security, Liquidity and Yield, must be still be considered.

Figure 2:



A summary of the investment decision making process for local authorities is shown in *Appendix 1*. The diagram shows there is a broad selection of investment products that can help to meet the varied liquidity needs.

Conventional investment are…

- Call / notice accounts
- Term deposit – 1 year (financials)
- DMADF
- Money Market Funds

Alternative investments – what are available?

- Treasury Bills
- Certificates of Deposit
- Collateralised Deposits
- **Wider range Money Market Funds (Enhanced Money Market Funds)**
- **Corporate Bonds**
- **Corporate Bond Funds**
- **Property Funds**
- Equity Funds
- Exchange Traded Funds

The following sections will go through the main alternatives available to UK Local Authorities and explain the risks associated with each investment type.

2. Enhanced Cash Funds/Money Market Funds

Bond / Cash Plus funds are longer dated than AAA rated MMFs, and have a variable net asset value (VNAV), which means the assets are marked to market on a daily basis and the unit price adjusted accordingly. Under this calculation basis the unit price can go up or down. With a stable NAV applied to MMFs, the assets are valued using the amortised cost method on a weekly basis and, barring significant market turbulence, the unit price is expected to show little or no alteration. The amortised cost method of valuation assumes assets purchased are held to maturity and can only be used on assets with a Weighted Average Maturity (WAM) of less than 90 days. As traditional MMFs have to keep their overall WAM to less than 60 days they can use this less volatile valuation method.

With a variable NAV fund, interest and principal are represented by a change in the value of the underlying NAV i.e. the interest earned during a given period would be calculated as the difference between the end and start price of the investment for example, if an investment of £100 was made today in a fund with variable NAV of 2, the investor would purchase 50 units of the Fund and the fair value of the investment would be £100. If the investment is re-priced one month later and the variable NAV is now 2.2, the investment is worth £110 (50 units x 2.2) and the interest earned during the month is £10 (2.2-2 x 50 units). This gain (uplift) would be booked as an 'unrealised gain', if the £100 remained invested and the £10 remained unrealised. It would become a ‘realised gain’ if the £100 investment was withdrawn and the gain of £10 capitalised. Similarly, had the NAV decreased over the period, the loss would be unrealised if the £100 remained invested or realised if the £100 were withdrawn minus the loss. Thus the unit price is made up of principal plus interest (accrued and realised), realised gains/losses and unrealised gains/losses.

Despite having liquidity ranging from T+1 to T+5, these Funds are typically used by investors with an investment horizon of at least 3 to 6 months. As previously mentioned, the NAV can move depending on market sentiment. However, in general terms the NAV is expected to rise as interest earned on investments outweighs any temporary negative valuation impact on the NAV, but this is not guaranteed. In addition, the Fund Manager will always try to limit any negative capital changes in its investments. Nevertheless, market circumstances may restrict the Manager’s ability to do this.

A significant portion of the portfolio may be invested in the same high-quality, short-term securities seen in traditional MMFs, such as Certificates of Deposits (CDs), Treasury Bills and Commercial Paper. However, the balance of the Cash Plus Fund portfolio may also be typically invested in a variety of higher-yielding, longer-term securities and/or institutions with slightly lower credit ratings. They can also invest in different asset classes and typically most (but not all) funds may hold Asset Backed Securities (ABS). ABS are a form of debt financing that involves the sale of specified assets, known as the collateral, into a Special Purpose Vehicle (SPV), a bankruptcy remote vehicle or trust. The collateral can be anything that can be securitised – car loans, home loans, commercial property, credit cards etc . ABS can be similar to the Asset Backed Commercial Paper (ABCP) that traditional MMFs hold but the collateral type is mostly homogenous and ABS typically have maturities beyond 1 year.

Enhanced Cash Funds differ from traditional AAA rated Money Market Funds (MMFs) in a number of ways.

They:

- Usually take more interest rate risk by managing the portfolio with a longer weighted average maturity (WAM), though still have restrictions on the maximum period. The longer the WAM the greater interest rate risk the Fund is exposed to and the more volatile the returns are likely to be. These returns can be negative or positive. During periods of rising interest rates longer duration Funds will produce lower returns with the opposite being true in times of falling interest rates, for a period of time whilst the fund’s yield re-aligns. Falling interest rates may also lead to capital gains in some negotiable instruments.

- May take greater credit risk by holding assets with lower credit ratings and/ or have a longer weighted average life (WAL). The longer the WAL the greater the credit risk. Some Funds use the same approach to credit selection as in their traditional shorter duration MMFs, whilst others use a mix of alternative instruments, including investment grade Corporate Bonds and Asset Backed Securities.

- Might be rated AAA, lower with volatility ratings, or, alternatively, not rated at all

- Typically offer less liquidity.

It should be noted that these Funds are designed to produce an enhanced return and this typically requires the manager to take more risk (whether credit, interest rate or liquidity) than traditional Constant Net Asset Value (CNAV) MMFs. This does not mean that there is a necessarily a reduction in credit quality but the funds can produce more volatile returns.

Longer-dated, wider-range funds can be a useful addition to a diversified Treasury portfolio. These funds are very different from traditional MMFs and even within the AAAf S1 / AAA/V1 / Aaa-bf rating scale there is a range of funds with very different characteristics. For example, the credit risk for some funds is restricted by the manager e.g. some would have a minimum holding criteria of short term rating of A1/P1 and long term rating of AA- (or equivalent) where others will allow use of CCC+ long term rating but the % holdings of this credit quality would be restricted to ensure the overall AAA fund rating is maintained. As the different approaches could produce significant variations in the credit quality and number of holdings within each fund, Sector would also suggest a review of the detailed portfolio(s) is undertaken as part of the investment decision process.

With a MMF the priorities are:

1) Security
2) Liquidity
3) Yield

In longer-dated, wider-range funds the priorities can be in a different order. For further details and analysis of ratings and characteristics, please see Capita Asset Services November 2012 – Enhanced Cash Fund Report.

3. Corporate Bonds

As from 1st April 2012, the CLG changed the rules on capital expenditure for English local authorities. This, from an accounting perspective, makes investment into corporate bonds much easier compared to the past, as they are no longer classified as capital spending.

In essence, companies issue bonds in order to raise long-term capital or funding, rather than issuing equity. These are non-standardised compared to other investment vehicles, each having an individual legal document known as a ‘bond indenture’. The document specifies the rights of the holder and the obligations that must be met by the issuer, as well as the characteristics of that particular bond. Investing in a corporate bond usually offers a fixed stream of income (except floating rate notes), known as a coupon, payable twice a year, for a fixed, predetermined period of time in exchange for an initial investment of capital.

Most bond investors prefer not to hold on to them until maturity, as they often offer very marginal capital growth. However, for local authorities, purely looking for a fixed stream of income, the 'buy and hold strategy'[1] is perhaps far more appealing, accounted for as an '*Available for sale'* investment. Though still an option for local authorities in need of liquidating positions, bond trading before maturity can be very risky especially during these volatile times and requires in depth fixed income knowledge/experience.

Corporate bonds are usually grouped by credit rating as the following;

- **Investment-grade bonds -** BBB or higher
- **High yield/Speculative/Junk bonds -** BB and below

Characteristics of some corporate bonds can include sinking fund provisions that help the issuer pay back the face value of the bond in instalments, protective covenants to protect income streams paid out and call/put provisions meaning benefits and drawbacks for both the issuer and investor during volatile market conditions.

There are many types of corporate bonds including; zero-coupon bonds, debentures which are usually secured by a floating charge, mortgage bonds which have security of specific collateral and unsecured bonds which are based solely on the credit quality of the issuer.

3.1. Benefits and Drawbacks of Investing in Corporate Bonds

The benefit for local authorities investing in corporate bonds can be the securing of a much higher rate of return for a given period, compared to Gilts and other assets. This on the other hand could be counterbalanced by their higher perceived risk. Furthermore, if needed, they potentially allow greater liquidity than fixed term deposits as they can be sold off before maturity, which again is counterbalanced by a risk of capital loss. However, the latter may not apply, as the 'buy and hold strategy' would be recommended for local authorities, based on current low interest rates expected to remain flat up until the third quarter of 2013, amongst other factors.

Investing in corporate debt can involve many drawbacks, one of which is credit risk. The risk that a large firm could miss its interest obligations is very rare. Nevertheless, the recent financial crisis has highlighted that not all firms are too big to fail. The market view of credit and interest rate risk can change very quickly as and when specific economic and corporate related data is released. This is the most important effect on price and yield changes of these bonds. This

[1] Note – A 'buy and hold strategy' would be accounted for as an 'Available for sale' investment. Buy and hold accounting would be reflected in the income and expenditure, with any bond price changes through the 'Available for sale' reserve.

perceived risk can be measured by credit rating agencies, or far better, by market derivatives called credit default swaps, which are, in effect, insurance policies on corporate bonds.

Market risk is relatively higher compared to Gilts as corporate bonds have a lower credit rating and perceived security, which can result in greater volatility. It is this instability in prices that could result in increased difficulty in actively trading such securities, another reason why the 'buy and hold strategy' is suggested to local authorities.

A brief summary of the risks which should be considered by local authorities before investing and during investments in corporate bonds, are shown below:

- **Interest rate risk -** an increase(decrease) in expectations of a rise in interest rates can lead to the price of a bond decreasing(increasing) due to the inverse price and yield relationship and vice versa

- **Inflation risk -** inversely related to interest rate risks. Real return can be eroded if inflation is expected to or will rise during the term of the bond, and thus coupon payments become less valuable.(Except Index-linked Gilts)

- **Re-investment risk (only if traded before maturity) -** the effect of changing interest rates on the return of re-investing coupon payments before maturity.

- **Credit risk -** credit quality/rating deterioration can lead to the value of the bond decreasing.

- **Default risk -** possibility that total principal may not be returned at maturity, or partially returned, resulting in capital loss. However, due to the pecking order of repayment at default, bond holders are above the owners of the company (Stock).

- **Call/Put provision risk -** the bond can be called by the issuer before maturity in a falling interest rate market, as cheaper funding can be sourced elsewhere and therefore re-investment risk is evident in a low interest rate period and vice versa.

Local authorities' preferred type of corporate bond would likely be a plain vanilla (repayment), investment grade bond, paying fixed coupons and denominated in sterling. Ideally, the maturity horizon currently suggested for these types of bonds, would be to invest in the short-end, within 1-2 years, as rates are expected to rise in the third quarter of 2013. Moreover, with most local authority counterparty lists recently squeezed in terms of numbers of counterparty institutions, as a result of rating agencies having made many sovereign and bank credit rating downgrades, diversifying into the non-financial sector could be beneficial.

An essential criterion to be aware of when selecting bonds, is the collateral classification for each bond. Even though it is recommended that local authorities invest in investment grade bonds, which are Capita Asset Services suggested-duration matched with maturity, that itself does not mean they are guaranteed risk free assets. If a corporate defaults on its bond payments, investors who take the least amount of risk are paid first. For this reason, creditors and bondholders who lend money to a company will be compensated before its stockholders, who own the company. Furthermore, the seniority of a bond is vital for local authorities when selecting these investments. Seniority refers to the order of which bonds will be repaid. The ranking order is:

1. **Senior secured**
2. **Senior unsecured**
3. **Subordinated**

The credit rating agencies play a crucial role in relation to this area of bond type, as they use this information and other fundamentals to evaluate their final ratings for each bond.

Custodian facilities will be required in order for local authorities to purchase corporate bonds. The relations with brokers and market makers will be useful in finding bonds that are both suitable and available in the market. With local authorities looking to invest in the short-end of the yield curve, searching for bonds which are actively traded in the market is important, as in most instances Money Market Funds, Pension Funds and other fund managers, are heavy buyers of short-term debt, whether financial/non-financial.

When investing in corporate bonds, the strategy of 'buy and hold till maturity' can only be valid if the Council's approved duration for the financial institutions covers the maturity periods of these bonds. It is for this reason that the list for corporate bonds can shrink drastically, when taking into account the suggested duration.

4. Corporate Bond Funds/ Collective Investments

An alternative option to direct corporate bond investments is corporate bond funds. Based on local authority preferences, a wide spectrum of different credit profiled corporate bonds can be present in the funds, or in combination with government bonds. In order to achieve that extra yield, local authorities may have to take on riskier assets, though that should not be at the sacrifice of security. To achieve this with minimal risk, corporate bond funds that include high yield bonds are an option to consider, as these spread risk amongst many corporate entities, which may or may not be financials.

Corporate bond fund investments provide many benefits in their own right. However, the key questions for local authorities looking to choose these funds are: whether they are the right type of fund and whether they encompass the preferred portfolio composition (asset allocation), in terms of meeting their objectives and risk profile. It is also important to note that local authorities should not merely look at the past record performance but also, importantly the future prospects of the individual investments via forecast of key economic fundamentals and fund manager guidance. Investing into funds should be viewed by local authorities as a long-term hold, preferably greater than a 5 year horizon.

The potential benefits of using the pooled investments include; reduced risk as a result of diversification where investments are spread across a greater number of institutions/products;

cheaper costs compared to transacting individually; professional management by regulated fund managers, reduced administration and research requirements by the investor for each investment.

There are a large number of corporate bond funds currently issued in the market. Capita Asset Services suggests that local authorities preferably use funds with a mixture of different fixed income securities and must be denominated in sterling. Furthermore, they should invest in funds that invest in bonds in a broad range of sectors, not just concentrated towards the volatile financial sector.

5. Property Funds

Local authorities with little property (i.e. Investment properties) exposure may also consider increasing diversification of their portfolio of assets into the property sector. Though the property market took a huge hit during the 'credit crunch of 2008', it has shown signs of recovery since 2011. The IPD Monthly Index has so far grown 4.7% over 2013. As the UK's annual GDP forecast is increased, as result of the European sovereign debt crisis easing somewhat, and investor confidence increases, capital and rental growth are likely to increase. Local authorities who may wish to consider investing for the medium to longer-term time horizon (preferably greater than a 5 years) could reap the rewards in the future, by accessing at these relatively low levels.

There are many routes to indirect property investments, from UK authorised property unit trusts to investment trusts, that each have their own characteristics and benefits for investors. Of particular interest, could be a new form of vehicle for property investment introduced in 2007, called 'Real Estate Investment Trusts' (REITS). The Local Authorities (Capital Finance and Accounting) (England) Regulations 2007 (SI 2007/573), amended previous set of laws to ensure that buying shares in REITs does not count as capital expenditure. These are usually companies that own and operate income-producing property, which can be commercial or residential. They are designed to securitise the income from rental property in a tax efficient way, which is a crucial advantage compared to standard property companies. Although the dividends are still income taxed, the 'double taxation' is eliminated at both the corporate and investor level. Another benefit of investing in REITs is that it has to follow strict guidelines from the fund composition, to the requirement to be listed on a reputable index, in order to achieve UK REIT status.

5.1. Benefits and Drawbacks of Investing in Property Funds

Property funds can provide stable returns in terms of fixed period rents, whether commercial or industrial rentals. Active management of property can achieve higher rental income than average, by selecting areas of growing demand or through refurbishments.

As well as providing attractive yields and helping to diversify portfolios, property funds need careful consideration as to how well the market is predicted to perform in relation to other asset classes, as timing is vital.

Investing into collective funds can cause many risks as well as benefits, such as illiquidity risk and concentration risk of having the fund tilted heavily towards geographical regions or certain types of properties. Price volatility risk can be apparent, especially when investments are concentrated to a particular common characteristic. A risk that cannot be overlooked is the gearing or leverage of these types of funds, which if high, could have detrimental effects in volatile market conditions.

Other financial risks include possible land and other tax changes, rental growth that could be location affected, overall market yield changes, and disadvantages from long exit time and additional exit fees. A simple risk that could easily be overlooked, or not mentioned, is the core quality of tenants, lease agreements and their possible hindering break clauses.

6. Equity Funds and Exchange Traded Funds

Exchange Traded Funds are not an asset class in themselves in the same way as Money market Funds, Bond Funds, Equity Funds etc. They are a derivation of these in that a manager can set up an ETF where underlying investments are money market instruments, equities, bonds etc. These types of fund were originally conceived in the US in an effort to provide investors with a relatively low cost, tax efficient method of gaining exposure to the underlying asset class. Unlike typical “funds”, these can be traded intra-day at the unit price at the time, rather than investors dealing at the end-day price.

These remain in their infancy in sterling markets, with the majority being equity based funds at present. There are a small, but growing number of bond and money market funds being created, but these are still relatively small and, therefore, unlikely to be of interest to our client base at the present time. We will continue to monitor developments in this area and will look to report back on progress that is made and how clients may look to take advantage of opportunities in this part of investment markets if they materialise. At the present time, using the more traditional fund methods of gaining exposure to the underlying asset types would seem most appropriate.

Equity funds are pooled investment vehicles that will focus investments primarily in UK equities. Unlike Money Market Funds where there is a similar focus (either government only, or wider range liquidity options) there is more diversification within types of equity fund. For example, there are funds which simply look to track an index – say FTSE-100. You will have other funds which focus on smaller stocks (ie within the FTSE-350) or those that only invest in large, “blue chip” stocks. Other funds may also have an income or a capital generation focus. In terms of appropriateness, there are a number of key factors that an investor has to consider before placing money in such funds. The first and perhaps most important is that all types of equity fund will have a long term investment time horizon. Although recent years have seen consistently strong annual performances, this is due to a recovering economic environment. However, when a downturn materialises, these value of these types of fund can lose significant level in very short periods of time. Most of the funds’ Key Investors Information Documents (KIIDs) will stipulate that they are only suitable for investors with a minimum investment time horizon of at least 5 years, underlying the potential volatility of returns. Although some clients will have this length of investment time horizon, these types of fund are not appropriate for the majority of clients.

7. Average Fund Returns (as at 31/10/13)

Average Returns				
Name	Num of Securities	Total 1 Year Return %	Total 3 Year Return % (Annualised)	Total 5 Year Return % (Annualised)
Bond Funds (IMA,£ List)	107	3.43	5.87	8.99
Property Funds	130	3.27	2.55	1.19
Equity Income Funds (IMA,£ List)	56	25.81	12.87	14.62
• FTSE All-Share Index (simple price change, excl re-investment of dividends	-	18.81	5.60	9.70

Appendix 1 - Investment decision making process for Local Authorities