

London Borough of Hammersmith & Fulham Pension Fund



Investment Governance Report – Quarter 3 2009

November 2009



Strategic Overview

Summary

The assets of the Scheme are considered in terms of four equally weighted sections. UK Equities, Overseas Equities, Dynamic Asset Allocation Mandates and the Matching Fund.

The UK Equities are managed by Majedie and the Overseas Equities by MFS. There are two Dynamic Asset Allocation managers, Barings and Ruffer, managing three quarters and one quarter of this section respectively. The Matching Fund is split equally between a global bond mandate managed by Goldman Sachs and a Liability Driven Investment (LDI) fund managed by Legal & General. With the exception of the LDI fund, all others are actively managed by fund managers who aim to meet or exceed their stated benchmark.

Liability Benchmark (LB)

To match the predicted growth in the liabilities, the Total Fund return needs to meet a return equivalent to the Liability Benchmark plus 1.75% p.a. (net of fees). The Total Fund strategy aims to exceed this and targets a return 2.5% p.a. (net of fees) in excess of the Liability Benchmark. Within this, the Matching Fund is targeting a return of 1%p.a. in excess of the Liability Benchmark.

The liabilities move in accordance with moves in relevant gilt yields. For this reason, the benchmark used to measure the estimated movement in liabilities, the "Liability Benchmark" is calculated based on the movement of a selection of Index Linked gilts, in the following proportions:

27% Index-linked Treasury Stock 2½% 2024, 63% Index-linked Treasury Gilt 1¼% 2027, 10% Index-linked Treasury Gilt 1¼% 2055

This Liability Benchmark was last reviewed in September 2008.

Manager Benchmarks

Each Investment Manager has a benchmark which they are monitored against on an ongoing basis. These are:

Majedie	<i>FTSE All Share + 2% p.a. over three year rolling periods</i>
MFS	<i>FTSE World ex UK + 2% p.a. over three year rolling periods</i>
Barings	<i>3 month Sterling LIBOR + 4% p.a.</i>
Ruffer	<i>3 month Sterling LIBOR + 4% p.a.</i>
Goldman Sachs	<i>3 month Sterling LIBOR + 2% p.a.</i>
Legal & General	<i>2 x FTSE + 15yr Index Linked Gilts - LIBOR p.a.</i>

Private Equity

Additionally, the Panel has agreed to invest up to £15 million in four private equity fund of funds. Two managed by Invesco, which has approximately 75% invested in the United States and 25% in Europe, and the other two by Unigestion which is invested almost entirely in Europe.

Performance Overview

Breakdown of Scheme Performance by Manager as at 30th September 2009

Fund	Manager	Market Value (£000)	% of Total Fund	Target % of Total Fund	3 month return (%)	Fiscal YTD (%)	1 year return (%)	3 year return (%)
Total Fund		505,232	100.0	100.0	15.2	22.7	16.8	5.3
<i>Liability Benchmark + 1.75% p.a.</i>					3.1	7.7	0.2	(1.7)
<i>Difference</i>					12.1	15.0	16.6	7.0
UK Equities		131,201	26.0	25.0				
Majedie					20.7	36.4	23.3	6.2
<i>FTSE All Share + 2% p.a.</i>					22.9	37.0	13.0	0.8
<i>Difference</i>					(2.2)	(0.6)	10.3	5.3
Overseas Equities		128,557	25.4	25.0				
MFS					23.4	27.4	16.9	6.1
<i>FTSE World ex UK + 2% p.a.</i>					22.3	30.2	14.2	4.8
<i>Difference</i>					1.1	(2.8)	2.6	1.3
Dynamic Asset Allocation Mandates		127,092	25.2	25.0	11.8	18.7	20.5	-
Barings (note 2)					12.5	19.7	17.6	-
<i>3 month Sterling LIBOR + 4% p.a.</i>					1.2	2.5	6.2	-
<i>Difference</i>					11.3	17.2	11.4	-
Ruffer (note 2)					9.8	15.5	29.3	-
<i>3 month Sterling LIBOR + 4% p.a.</i>					1.2	2.5	6.2	-
<i>Difference</i>					8.6	12.9	23.1	-
Matching Fund		118,382	23.4	25.0	5.7	9.9		
<i>Liability Benchmark + 1% p.a.</i>					2.9	7.3		
<i>Difference</i>					2.8	2.6	-	-
Goldman Sachs					3.4	7.3	2.5	(1.3)
<i>3 month Sterling LIBOR + 2% p.a.</i>					0.7	1.3	(3.4)	(3.5)
<i>Difference</i>					2.7	6.0	6.0	2.3
Legal & General (note 3)					7.9	12.5	11.3	4.6
<i>2 x FTSE + 15yr IL Gilts - LIBOR p.a.</i>					5.5	1.6	(12.6)	(5.4)
<i>Difference</i>					2.4	10.9	23.9	10.0

Notes:

- 1) All numbers are sourced from the Custodian, Northern Trust, and have not been independently verified.
- 2) Performance for Ruffer and Barings is for less than 3 years. Date of inception for Ruffer is 7th August 2008. Date of inception for Barings is 19th August 2008.
- 3) At the time of reporting, the L&G mandate consisted of index linked gilts, the first step of the new LDI mandate. The longer term benchmark consists of a blend of benchmarks, reflective of LGIM's previous holdings.

Asset Reconciliation and Valuation

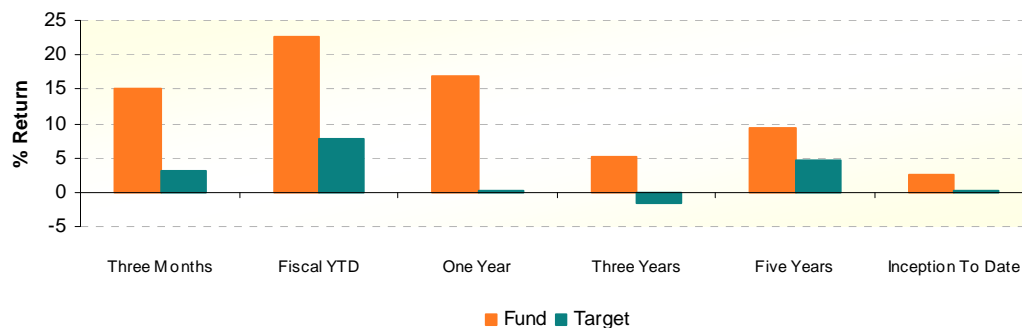
Asset Reconciliation and Valuation

Fund	Manager	Opening Market Value as at 30 June 2009 £000	% of Total Fund	Net Investment £000	Appreciation £000	Income Received £000	Closing Market Value as at 30 Sept 2009 £000	% of Total Fund	Target % of Total Fund
Total Fund		438,511	100.0	21	64,808	1,892	505,232	100.0	100.0
UK Equities	Majedie	108,679	24.8	0	21,244	1,278	131,201	26.0	25.0
Overseas Equities	MFS	104,152	23.8	(0)	23,974	431	128,557	25.4	25.0
Dynamic Asset Allocation Mandates		113,635	25.9	21	13,255	181	127,092	25.2	25.0
	Barings	84,984	19.4	21	10,627	0	95,632	18.9	18.8
	Ruffer	28,651	6.5	0	2,628	181	31,460	6.2	6.2
Matching Fund		112,045	25.6	0	6,335	2	118,382	23.4	25.0
	Goldman Sachs	54,691	12.5	0	1,836	1	56,528	11.2	12.5
	Legal & General	57,354	13.1	0	4,499	1	61,854	12.2	12.5

Notes: All numbers are sourced from the Custodian, Northern Trust and have not been independently verified.

Overall Performance

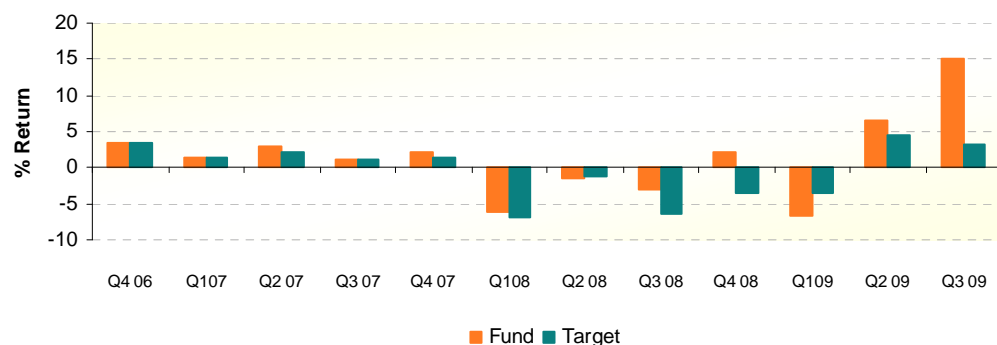
Historical Plan Performance



	Three Months	Fiscal YTD	One Year	Three Years	Five Years	Inception To Date
Fund	15.21	22.66	16.79	5.29	9.25	2.68
Target	3.09	7.70	0.18	-1.73	4.55	0.28

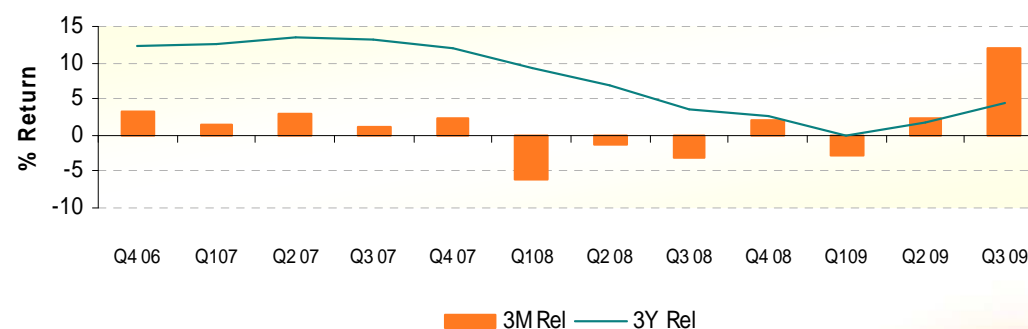
The Scheme outperformed its liability benchmark over the quarter, returning +15.2% compared to the target of +3.1%. The outperformance can be attributed to all areas of the Strategy. There was also significant outperformance over the last 12 months, of +16.6%, primarily due to outperformance from Majedie, Ruffer and Legal & General. Overall the Scheme has outperformed well on a 3 and 5 year basis.

Three Years Rolling Quarterly Returns



	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
Fund	3.35	1.37	2.87	1.09	2.28	-6.13	-1.39	-3.11	2.03	-6.68	6.46	15.21
Target	3.41	1.5	2.28	1.05	1.36	-6.85	-1.23	-6.35	-3.61	-3.5	4.47	3.09

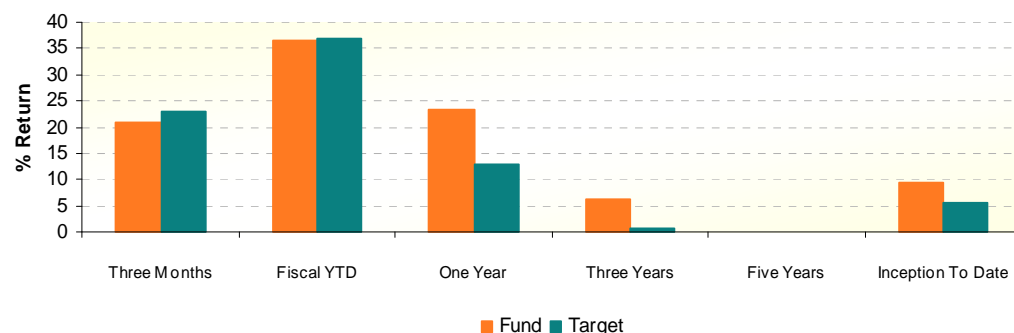
Three Years Rolling Relative Returns



	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
3M Rel	3.35	1.37	2.87	1.09	2.28	-6.13	-1.39	-3.11	2.03	-2.9	2.3	12.06
3Y Rel	12.32	12.5	13.41	13.26	12.13	9.25	6.75	3.56	2.51	-0.14	1.81	4.32

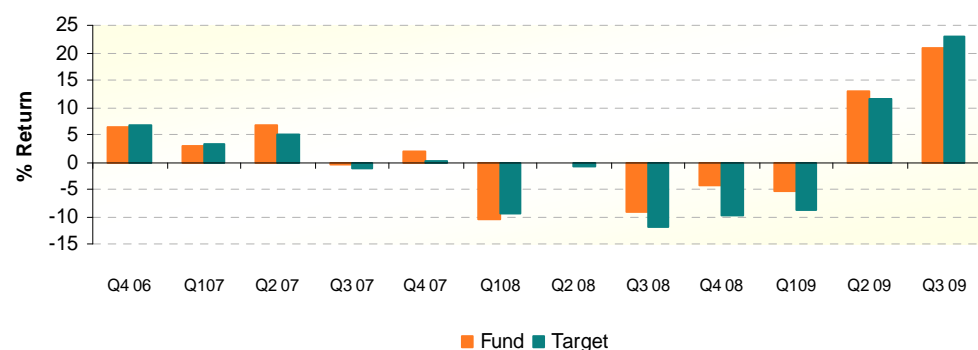
Majedie are a small boutique specialist active UK Equity manager with a flexible investment approach. Their approach to investment is mainly as stock pickers. They were appointed in July 2005 following a OJEU tender process. They started managing investments for the fund in August 2005.

Historical Plan Performance



	Three Months	Fiscal YTD	One Year	Three Years	Five Years	Inception To Date
Fund	20.72	36.38	23.28	6.15	-	9.23
Target	22.94	37.00	12.98	0.84	-	5.46

Three Years Rolling Quarterly Returns



	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
Fund	6.41	3.07	6.84	-0.38	2.03	-10.35	0	-9.13	-4.38	-5.47	12.97	20.72
Target	6.68	3.42	5.06	-1.27	0.15	-9.41	-0.96	-11.75	-9.74	-8.63	11.43	22.94

Quarterly Manager update

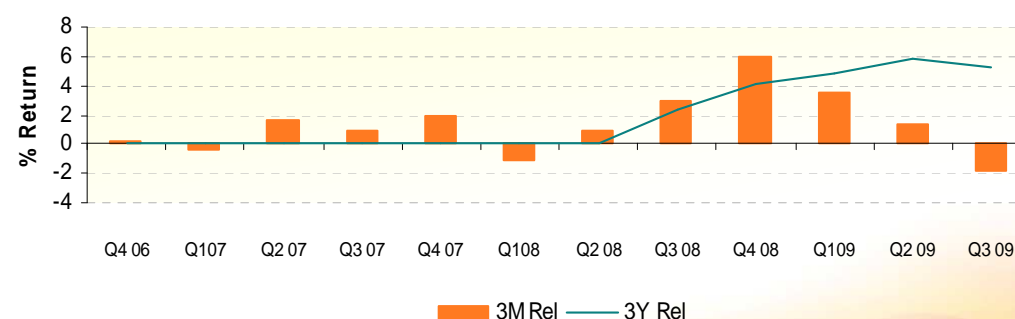
Organisation Over the quarter, the number of investment professionals at Majedie increased by more than 10%. No joiners perceived as core to this mandate.

Product No significant changes over the quarter.

Performance The fund performance was 20.7% over the quarter, 2.2% behind its target. Over 12 months, they are 10.3% ahead of their target, despite the volatile market conditions. Defensive shares recorded strong performance during the past 12 months. Earlier in the year, Majedie took advantage of opportunities to purchase strong companies at depressed levels, as their conviction grew that economies were stabilising.

Process No significant changes over the quarter.

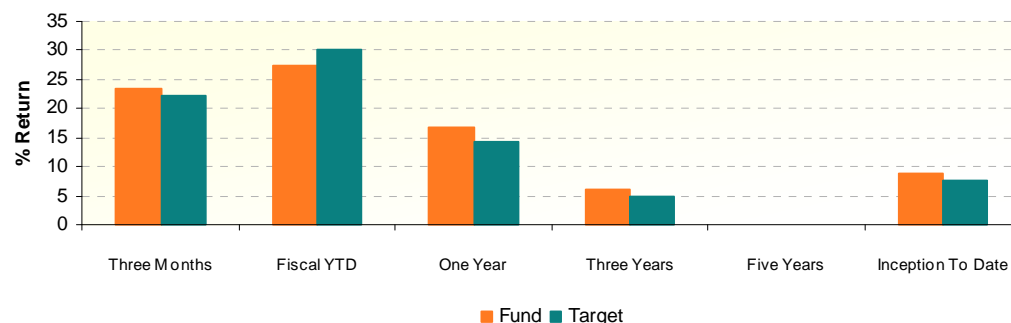
Three Years Rolling Relative Returns



	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
3M Rel	0.26	-0.34	1.7	0.91	1.88	-1.05	0.96	2.96	5.94	3.46	1.38	-1.81
3Y Rel	-	-	-	-	-	-	-	2.38	4.13	4.88	5.82	5.27

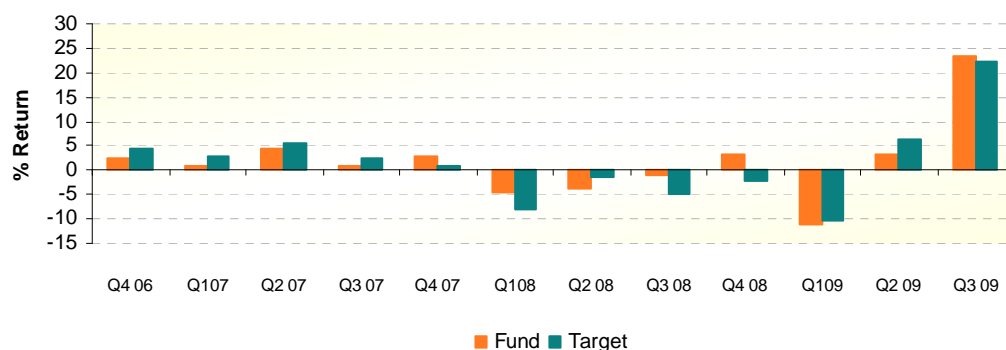
MFS are owned by Sun Life Financial based in Boston. Their investment philosophy is to select the best investment opportunities across regions and sectors. They were appointed in July 2005 following a OJEU tender process. They started managing investments for the fund in August 2005.

Historical Plan Performance



	Three Months	Fiscal YTD	One Year	Three Years	Five Years	Inception To Date
Fund	23.43	27.42	16.85	6.11	-	8.94
Target	22.3	30.18	14.24	4.84	-	7.47

Three Years Rolling Quarterly Returns

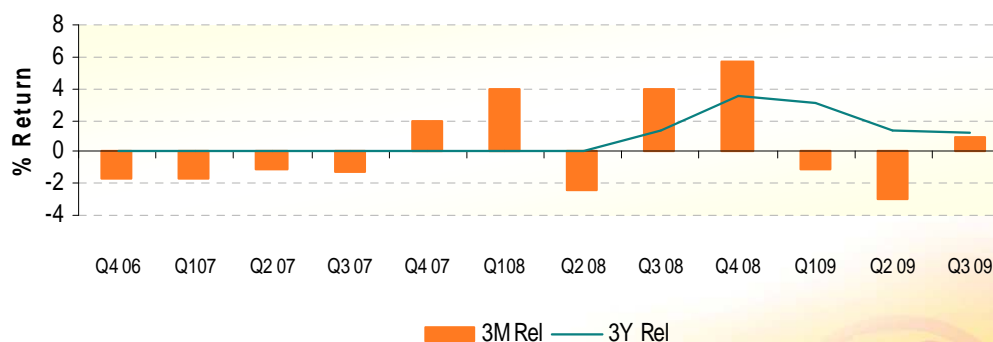


	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
Fund	2.51	1.07	4.23	0.99	2.95	-4.44	-3.72	-1.02	3.29	-11.21	3.23	23.43
Target	4.26	2.8	5.43	2.28	0.94	-8.05	-1.27	-4.76	-2.22	-10.25	6.44	22.3

Quarterly Manager update

Organisation	No significant changes over the quarter.
Product	There is no set maximum capacity of this product, but based on current asset levels and expected flows, MFS believe that they are approaching full capacity. They do not project an exact time to reach maximum capacity. We will continue to monitor this. In October 2009, MFS had a personnel change - Roger Morley joined as co-portfolio manager for the strategy.
Performance	The fund performance was 23.4% over the quarter, 1.1% ahead of its target. Over 12 months, they are 2.7% ahead of their target. Global Equity markets have rallied significantly over the past 6 months. MFS have a high proportion of their holdings in US Equities, which have seen strong returns in recent periods.
Process	No significant changes over the quarter.

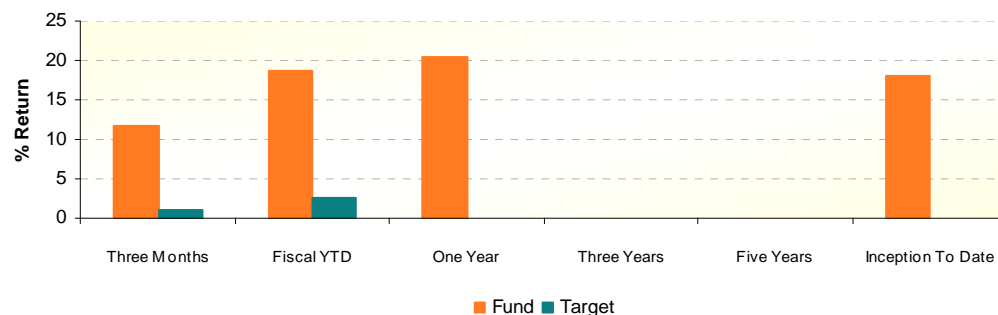
Three Years Rolling Relative Returns



	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
3M Rel	-1.68	-1.68	-1.15	-1.27	2	3.92	-2.48	3.93	5.64	-1.07	-3.02	0.92
3Y Rel	-	-	-	-	-	-	-	1.32	3.5	3.02	1.32	1.21

Dynamic Asset Allocation Group

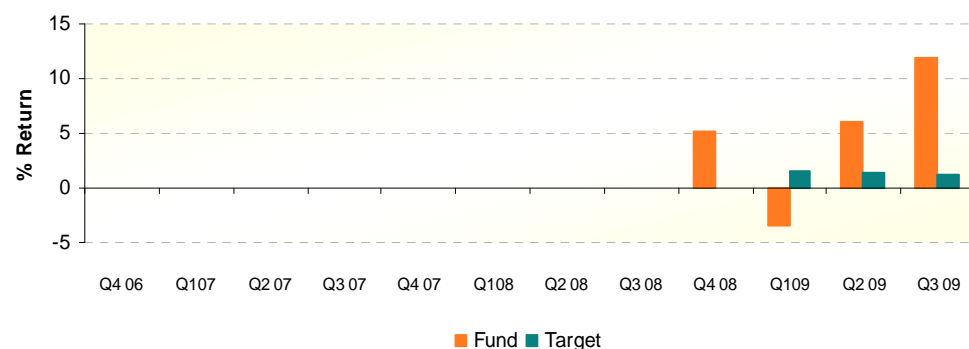
Historical Plan Performance



The group has returned 11.8% over the quarter compared to its LIBOR-based target of 1.2%, due to strong performance from both Barings and Ruffer. Over the year to date, performance has been above target, as both Barings and Ruffer have outperformed. The Dynamic Asst Allocation group in general has benefitted from the strong performance from the equity components of their portfolios.

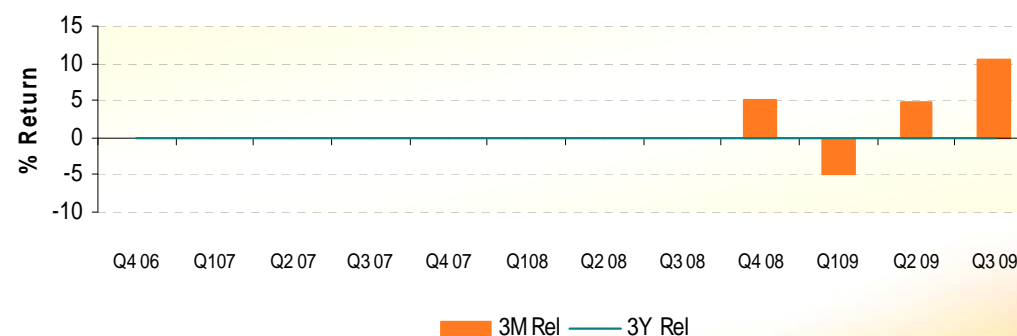
	Three Months	Fiscal YTD	One Year	Three Years	Five Years	Inception To Date
Fund	11.82	18.65	20.53	-	-	18.12
Target	1.19	2.54	-	-	-	-

Three Years Rolling Quarterly Returns



	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
Fund	-	-	-	-	-	-	-	-	5.14	-3.38	6.1	11.82
Target	-	-	-	-	-	-	-	-	-	1.19	1.19	1.19

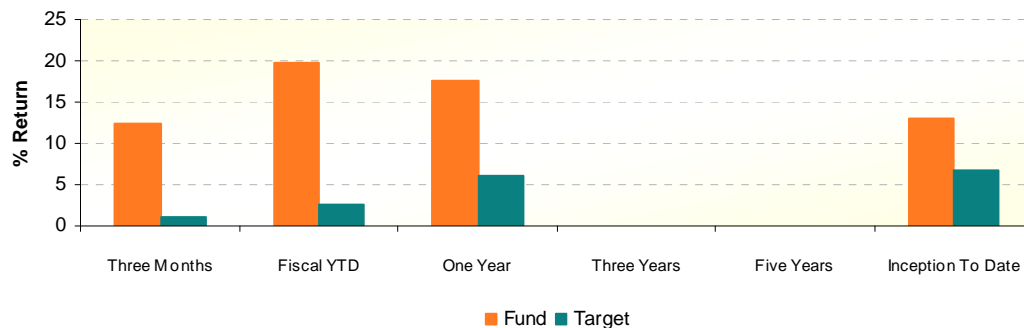
Three Years Rolling Relative Returns



	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
3M Rel	-	-	-	-	-	-	-	-	5.14	-4.81	4.71	10.51
3Y Rel	-	-	-	-	-	-	-	-	-	-	-	-

Barings are a large UK based investment manager investing in global asset classes. They were appointed for the Dynamic Asset Allocation mandate in June 2008 following a OJEU tender process. They started managing investments for the fund in July 2008.

Historical Plan Performance

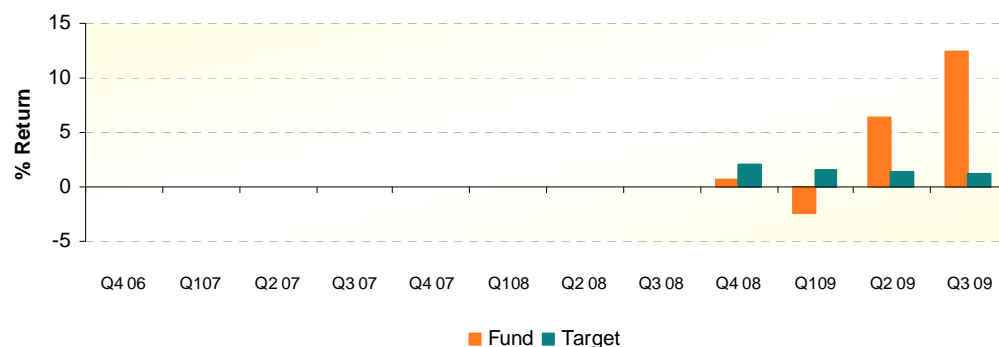


	Three Months	Fiscal YTD	One Year	Three Years	Five Years	Inception To Date
Fund	12.5	19.72	17.61	-	-	13.01
Target	1.19	2.54	6.17	-	-	6.7

Quarterly Manager update

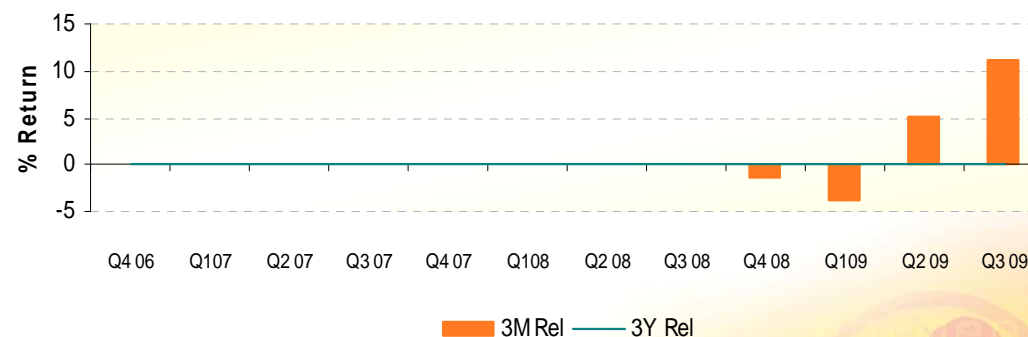
Organisation	No significant changes over the quarter.
Product	No significant changes over the quarter.
Performance	The fund performance was 12.50% over the quarter, 11.3% ahead of its target. Over 12 months, they are 11.4% ahead of their target. Equity markets rose quickly in the summer months as signs of economic recovery were present. Emerging market returns were very similar to major markets. Other risk assets have also rallied sharply. Investment grade corporate bonds in the UK are up significantly, while the rally in lower quality high yield bonds has been even more substantial.
Process	No significant changes over the quarter.

Three Years Rolling Quarterly Returns



	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
Fund	-	-	-	-	-	-	-	-	0.67	-2.42	6.42	12.5
Target	-	-	-	-	-	-	-	-	2.01	1.5	1.33	1.19

Three Years Rolling Relative Returns

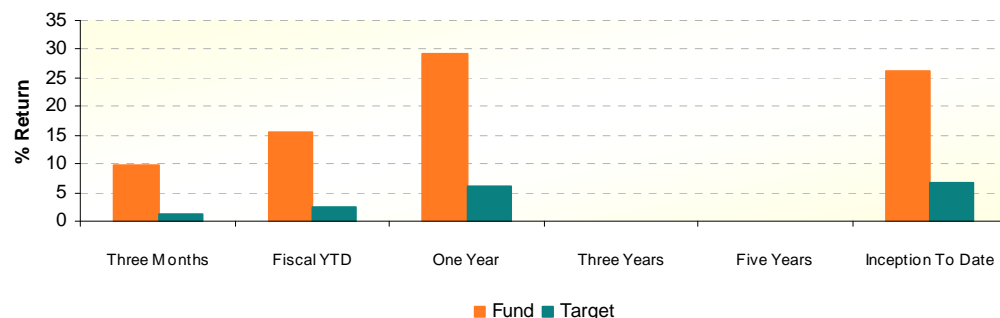


	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
3M Rel	-	-	-	-	-	-	-	-	-1.32	-3.87	5.02	11.18
3Y Rel	-	-	-	-	-	-	-	-	-	-	-	-

Ruffer

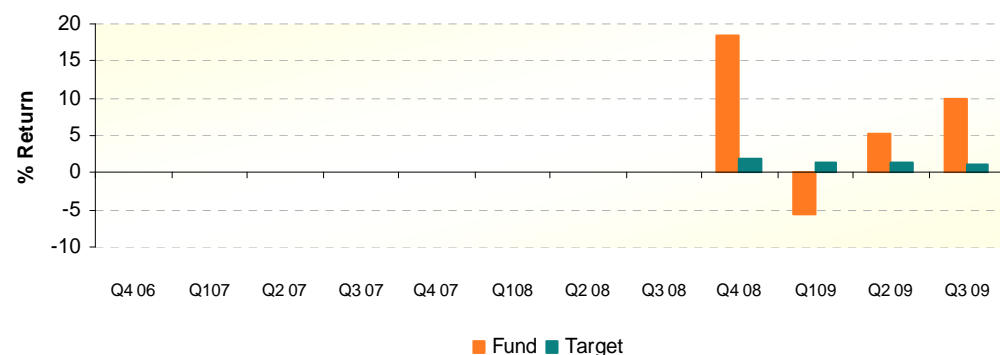
Ruffer are a small boutique investment manager investing in global asset classes. They were appointed for the Dynamic Asset Allocation mandate in June 2008 following a OJEU tender process. They started managing investments for the fund in July 2008.

Historical Plan Performance



	Three Months	Fiscal YTD	One Year	Three Years	Five Years	Inception To Date
Fund	9.81	15.48	29.3	-	-	26.24
Target	1.19	2.54	6.17	-	-	6.7

Three Years Rolling Quarterly Returns

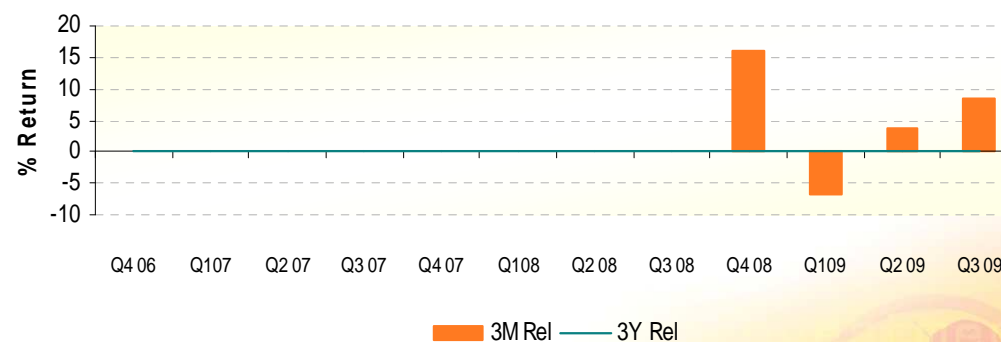


	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
Fund	-	-	-	-	-	-	-	-	18.47	-5.49	5.17	9.81
Target	-	-	-	-	-	-	-	-	2.01	1.5	1.33	1.19

Quarterly Manager update

Organisation	No significant changes over the quarter.
Product	No significant changes over the quarter.
Performance	The fund performance was 9.8% over the quarter, 8.6% ahead of its target. Over 12 months, they are 23.1% ahead of their target. Ruffer had enough equity exposure to make steady progress, though less than the equity indices, given their multi-asset approach. They had been increasing equity positions steadily during the year, in particular towards more economically sensitive stocks. In addition, index-linked gilt holdings performed well in the UK, US and Japan.
Process	No significant changes over the quarter.

Three Years Rolling Relative Returns

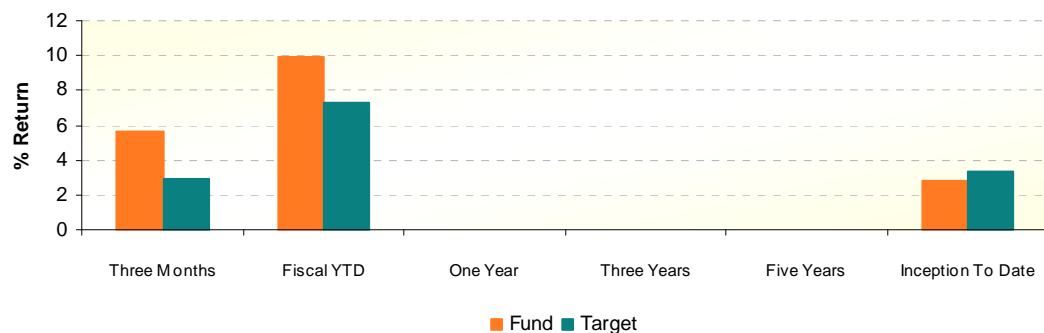


	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
3M Rel	-	-	-	-	-	-	-	-	16.14	-6.9	3.79	8.52
3Y Rel	-	-	-	-	-	-	-	-	-	-	-	-

Notes: All numbers are sourced from the Custodian, Northern Trust and have not been independently verified.

Matching Fund

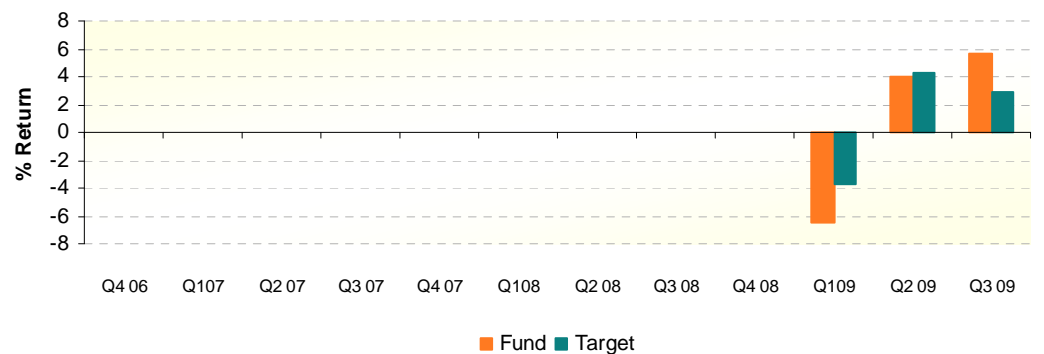
Historical Plan Performance



The performance of the Matching Fund over the quarter of 5.7% is above its gilts-based liability benchmark. This can be attributed to strong outperformance of both Goldman Sachs and Legal & General. Performance over the fiscal year to date is also ahead of the target.

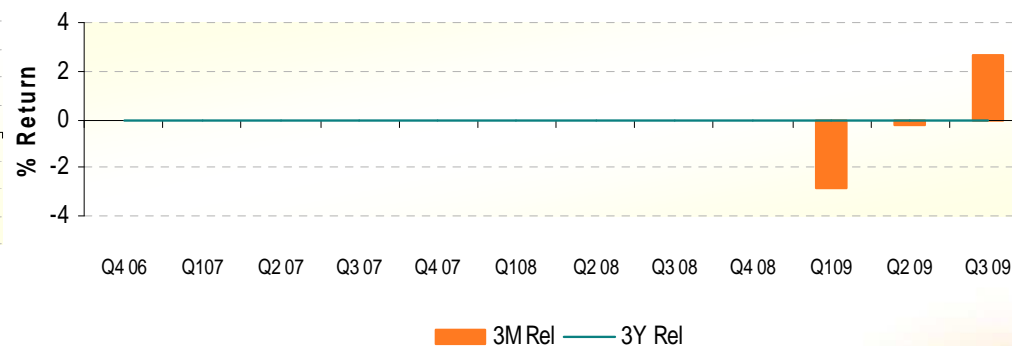
	Three Months	Fiscal YTD	One Year	Three Years	Five Years	Inception To Date
Fund	5.66	9.93	-	-	-	2.84
Target	2.9	7.3	-	-	-	3.35

Three Years Rolling Quarterly Returns



	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
Fund	-	-	-	-	-	-	-	-	-	-6.45	4.04	5.66
Target	-	-	-	-	-	-	-	-	-	-3.68	4.28	2.9

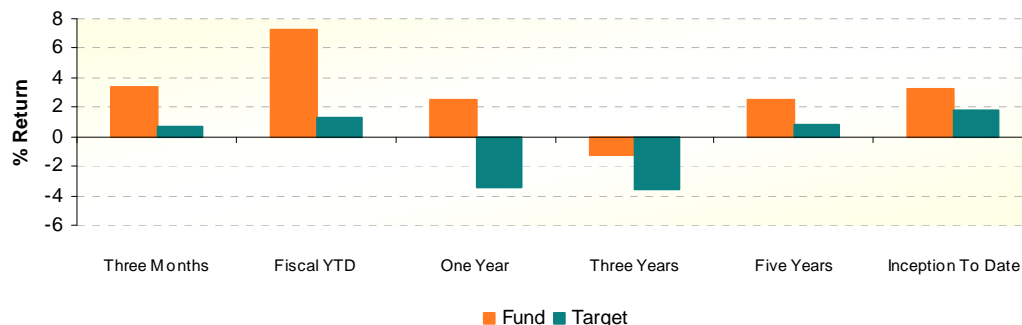
Three Years Rolling Relative Returns



	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
3M Rel	-	-	-	-	-	-	-	-	-	-2.87	-0.23	2.68
3Y Rel	-	-	-	-	-	-	-	-	-	-	-	-

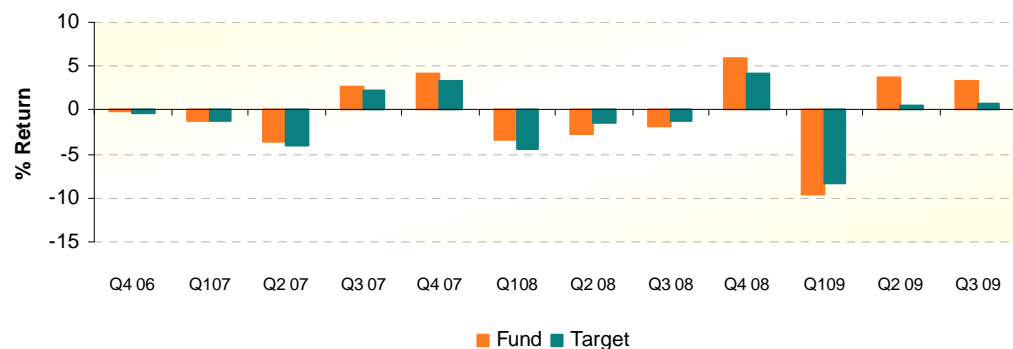
Goldman Sachs are a very large American investment bank who were first appointed in 1999 following a tender process. They have managed both equities and bonds on an active basis and since Feb 09 manage an active bond fund.

Historical Plan Performance



	Three Months	Fiscal YTD	One Year	Three Years	Five Years	Inception To Date
Fund	3.36	7.27	2.54	-125	2.5	3.21
Target	0.7	127	-3.44	-3.53	0.83	178

Three Years Rolling Quarterly Returns

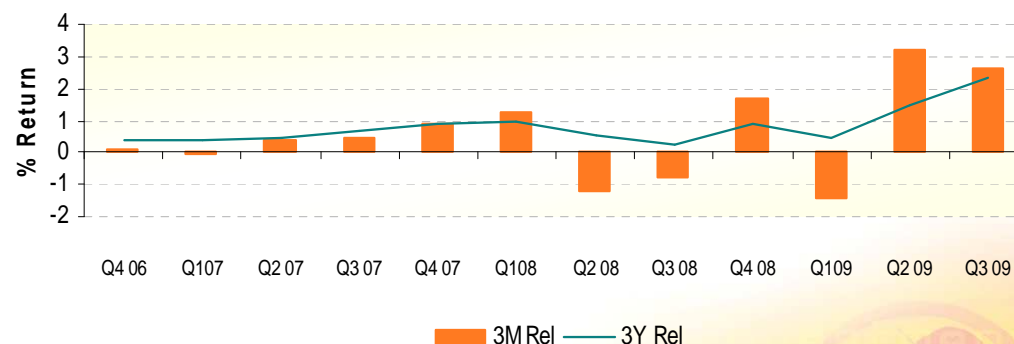


	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
Fund	-0.22	-1.24	-3.55	2.6	4.24	-3.27	-2.67	-1.86	5.86	-9.7	3.78	3.36
Target	-0.3	-1.16	-3.93	2.15	3.29	-4.46	-1.48	-1.12	4.09	-8.39	0.56	0.7

Quarterly Manager update

Organisation	No significant changes over the quarter.
Product	No significant changes over the quarter.
Performance	The fund performance was 3.4% over the quarter, 2.7% ahead of its target. Over 12 months, they are 5.9% ahead of their target. The overweight allocation to Corporate and Mortgage Backed Security credit sectors benefited the portfolio as the increase in investor risk appetite and demand for risky assets caused credit spreads to tighten. Exposure to credit-sensitive mortgages was a major positive contributor to performance and security selection strategies all contributed to positive excess returns the portfolio.
Process	No significant changes over the quarter.

Three Years Rolling Relative Returns

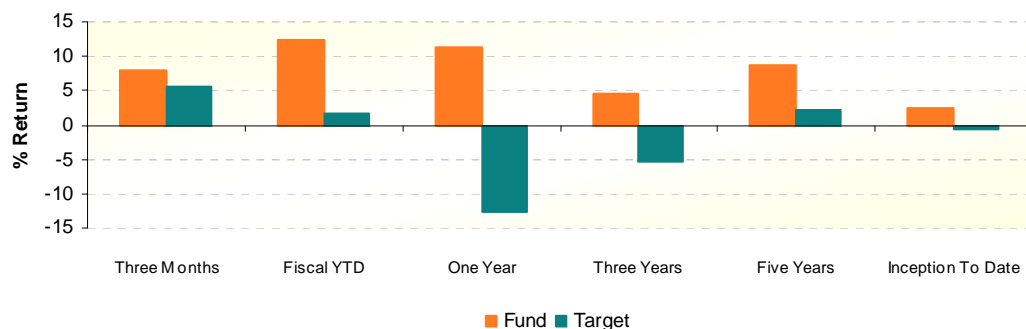


	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
3M Rel	0.08	-0.08	0.39	0.44	0.91	1.24	-1.21	-0.74	1.7	-1.43	3.2	2.64
3Y Rel	0.41	0.35	0.49	0.67	0.89	1	0.54	0.27	0.9	0.47	1.48	2.37

Legal & General

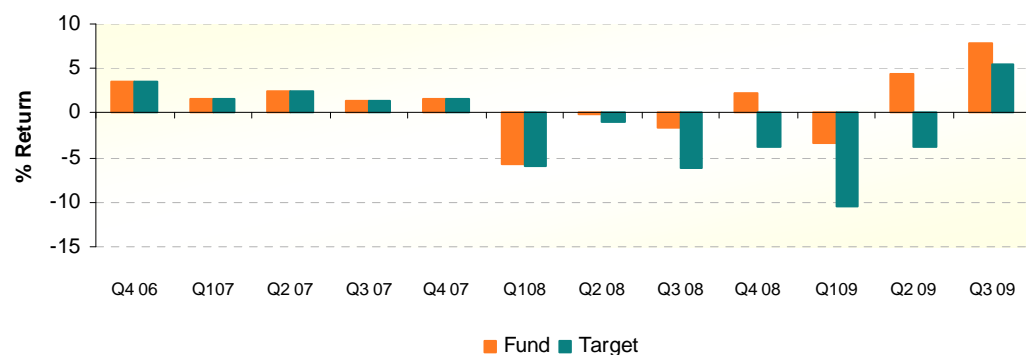
Legal & General are a very large manager of indexed funds. They were first appointed to manage investments for the fund in 1993. They have managed both equities and bonds on and indexed basis. Their current investment mandate started in July 2009 following the investment structure review.

Historical Plan Performance



	Three Months	Fiscal YTD	One Year	Three Years	Five Years	Inception To Date
Fund	7.85	12.47	11.28	4.56	8.73	2.5
Target	5.49	1.58	-12.61	-5.42	2.32	-0.64

Three Years Rolling Quarterly Returns

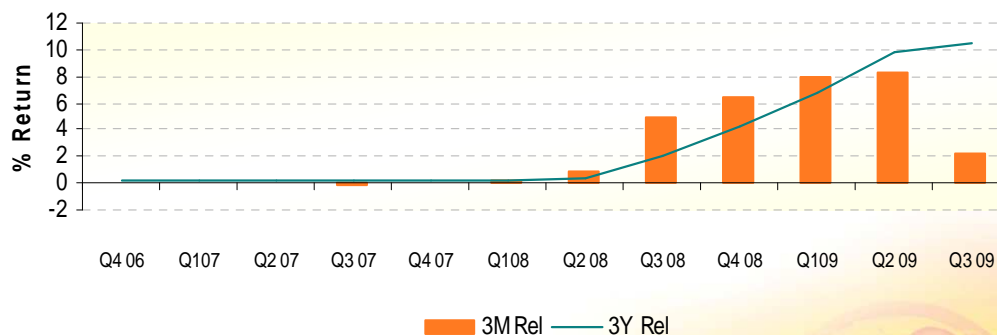


	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
Fund	3.51	1.53	2.51	1.34	1.66	-5.79	-0.17	-1.6	2.34	-3.32	4.29	7.85
Target	3.45	1.51	2.46	1.42	1.67	-5.98	-0.99	-6.25	-3.9	-10.48	-3.71	5.49

Quarterly Manager update

Organisation	No significant changes over the quarter.
Product	No significant changes over the quarter.
Performance	At the end of the previous quarter, the L&G mandate consisted of corporate bonds and index linked gilts. These were sold after the quarter end to fund the new LDI mandate, and the Scheme has held just the 2055 Index-Linked Gilt Fund since 8th July 2009. This fund has tracked its benchmark since inception. Index-Linked gilts in general performed modestly compared to other asset classes over the quarter, however the fund itself achieved its objective of tracking its benchmark since inception.
Process	No significant changes over the quarter.

Three Years Rolling Relative Returns



	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09
3M Rel	0.06	0.02	0.05	-0.08	-0.01	0.19	0.83	4.97	6.49	8	8.31	2.23
3Y Rel	0.16	0.16	0.18	0.12	0.12	0.12	0.42	2.03	4.16	6.83	9.74	10.54

Notes: All numbers are sourced from the Custodian, Northern Trust and have not been independently verified.

Market Commentary

16th October 2009

This is a general market commentary for our pension fund clients covering the events of Q3 2009.

For equity and corporate bond investors Q3 has generally been a continuation of the good news from Q2.

We are now one year on from the collapse of Lehman's. The past year saw the beginning of the global intervention of governments to rescue many major players in the financial markets, to maintain the stability of financial markets as a whole. The good news is that the world has not fallen into the great depression that many commentators forecast at the time. However, this does not mean that the global economy is out of the woods yet. This applies, in particular, to the western economies who have significant levels of public debt that has been incurred from rescuing banks and increasing public spending to deal with the crisis. As a result of this, public sector spending will come under increasing pressure and tax rises will be needed to repair the damage to national finances. The key solution to removing this global debt problem relies on consumers in the UK and US to start saving and spending less, and for Asian and Japanese consumers to consume more.

On the positive side, in the central eurozone we have seen Germany, France and Italy emerge from technical recession this quarter. In Asia, we saw Hong Kong and Japan do the same. In the US, Mr Bernanke, Federal Reserve Chairman announced in September that they had "most probably left recession although recovery would probably be weak".

Looking first at Japan, its announcement of its emergence from recession was not greeted with unbridled enthusiasm in the stock market. The anticipated level of annual growth of 3.7% was lower than the market's anticipated 3.9%.

Japan was a proponent of quantitative easing and spent nearly £159bn on government stimulus, including cash hand outs. In line with the UK, US and Germany - who by spending €5bn was one of the most generous - Japan also gave subsidies for buying new cars. Despite this, the level of private domestic consumption in Japan remains low and this is a key concern over the longer term.

Despite all the attempts by the countries mentioned above to stimulate demand for their motor industries, in August China overtook the US to become the largest market for new private car sales.

It saw a 90% increase in sales over the past year, buoyed by tax incentives and targeted lending by the state. The Chinese government has not showed any willingness to cut back on economic and fiscal stimulus in its aim to reach economic growth of 8% this year (currently at 7.1% year on year for the first half of 2009). The maintenance of social stability and employment levels is its primary goal.

The weakness of Sterling over Q3 has helped unhedged Sterling investors to benefit from both rising equity market returns and the relative strength of overseas currencies. For Sterling investors, the Asia Pacific region (excluding Japan) has been a strong source of return for the year to date only exceeded by the emerging markets sector with double digit gains. In the case of Japan, the strength of the Yen has over turned a 12 month negative return to be positive. Over the 12 months to 30 September 2009, a -16.2% return for local Yen investors became a positive return for unhedged Sterling investors of 10.8%.

The importance of the Asia Pacific, China and the emerging markets in this region was reinforced with the announcement that HSBC's Chief Executive was going to relocate to Hong Kong the bank's historical head quarters. With this move five out of the world's ten largest banks by market capitalisation will be in Asia. This statistic illustrates how the impact of the previous year has hurt the market capitalisation of western banks and how the banks in Asia Pacific and Australia have avoided the worst of the previous year's financial damage to their balance sheets.

In the UK, we have seen the Monetary Policy Committee (MPC) increase the amount to be committed to quantitative easing from the original £150bn set aside by the Chancellor Alistair Darling to £175bn. This additional £25bn - together with £25bn remaining - from the original sum will be available to spend until March 2010. The comments from Mervyn King, the Chairman of the Bank of England, following this announcement focused on a deeper than expected recession in the UK. The announcement that UK retail sales fell in August accompanied by the Retail Prices Index showing continued deflation helped to vindicate the MPC's decision.

This concern for a weak pick up in consumer demand is not a welcome sign as it may indicate a lack of available credit to consumers.

Note: To put past performance into context, the market commentary is not updated to take into account any events after the date of production.

Market Commentary

16th October 2009

It also helped the MPC to maintain their view that interest rates in the UK need to remain low to help stimulate lending, by making it affordable, and to help revive growth in the wider economy. The level of public sector debt in the UK and the ability to reduce public spending is increasing the pressure on the strength of Sterling and in turn on the attractiveness of UK gilts to overseas investors. Mervyn King has made comments that he is not unhappy to see Sterling weaken. This has been taken by the currency markets that interest rate rises are further away than anticipated. His rationale for this stance is to make Britain more competitive in export markets in particular the eurozone. The reverse strategy seems to have been adopted by the Japanese Finance Minister, Hirohisa Fujii, who has commented that he was not unhappy with a strong Yen.

The currency then moved toward the Y90 to the US\$1, a level at which the Japanese have traditionally intervened to weaken their currency to help make Japanese exports more attractive, in particular to the US. This position was rapidly reversed when he realised the impact of his comments had pushed the Yen to an historic high against the US dollar.

Moving to the US, the last few days of Q3 saw a surge of merger and acquisition (M&A) activity in the US health care sector, with Johnson & Johnson and Abbott Laboratories both making bids for two European based companies with the aim of gaining access to flu vaccines and pharmaceutical distribution in the emerging markets respectively. Outside of the health care sector Xerox and Kraft have also made bid approaches, with Kraft's move on Cadbury's in the UK being a hostile bid. These deals are significant as they highlight the ability of Blue Chip companies to access funding – debt – for these acquisitions.

The commodity making the headlines in Q3 has been Gold, for breaching the \$1000 level during Q3 for the second time in 2009. The magic level did not hold with the price falling back to the high \$900s by the end of Q3. Commentators have noted the price has been well supported on dips by Chinese buying, possibly as a way of diversifying their reserves away from the US dollar. Commodities in general have had a weak quarter. The low usage level of potential global capacity, as evidenced by rising unemployment levels, has kept the economic bell weather oil price trading around the mid \$60 level over Q3.

Looking at the bond and money markets we have seen the London Inter Bank Rate, the rate at which banks lend to each other, continue to trend to a normal premium to the bank rate - just 0.0025% over the current bank rate 0.50% compared to the 0.6000% premium seen at the beginning of 2009. This indicates a greater trust among the banks to lend to each other once more.

Corporate and High Yield bonds continued to provide attractive returns to investors over Q3. However, the rally we have seen over Q2 and Q3 has led to a reduction in the yield, over government bonds, to low double digits from the highs we saw at the end of last year into the beginning of 2009 back to similar levels prior to the Lehman's collapse in August 2008.

This general spread reduction has led to an increase in corporate bond issuance as the cost of debt for investment grade companies has reached its lowest level for more than a year. This availability of cheaper, lower spread over government bonds, debt, has helped fuel the merger activity in the equity markets and increased the general liquidity in the bond markets.

While this availability of cheaper financing will be welcome by companies, the normalisation of corporate bond yields will lead to an increase in accounting liabilities for pension funds, although the rise in equity asset values and High Yield bonds will have helped mitigate some of this.

Outlook

The actions of the central banks and governments to avoid a global recession can be summed up by a quote from the film *The Great Escape* "we have a map of Germany but we don't know what lies 200 yards beyond the trees". This is true of the "map" that has been used to pump stimulus into the monetary system over the past year.

The greater economic plan has been clear, escape from (Germany) depression. The indications over this past quarter are that we are now over the wire, but we now need to make it past the trees and beyond "Germany's" border to economic freedom. However, before we reach "safety" we need to pass safely through the unknown. We now lie in the uncertain period, beyond the trees, and a full recovery relies on a sustainable level of consumption and bank lending to keep the wheels of recovery and, importantly, growth oiled. The global economy is on its way but like the escapers the euphoria of freedom needs to be tempered with caution as a volatile journey lies ahead.

Sources: Bloomberg, Reuters, ONS, PBOC

Hot Topics – Remember to Focus

October 2009

The battle against our ailing memory

A year ago many trustees found themselves in the situation where, if elements of the banking industry had gone under, pension scheme cash would have disappeared. We can argue whether the Bank of England should or would have let these banks go under. The issue was simply that the risk associated with the banking industry increased dramatically to a point probably not seen for many years. Arguably we saw it in Sweden in the early nineties, but that was localised – and so, the biggest comparison is as far back as the 1930s. Some trustees will have rushed to put in place controls over the use of cash, and limits to exposure on specific cash positions.

It is actually not that long ago we did this before. As an industry, the collapse of Barings in 1995 resulted in the same action. As I'm sure we all remember, in 1995, Nick Leeson managed to put under Barings Bank through trading far too much in Japanese equity futures.

As clients of Barings on the asset management side started to work out whether their assets were still there, an unexpected conclusion emerged – the equity and bond assets, i.e. the securities, were safe. However, as Barings did its own custody, any cash held awaiting investment was held on the Barings balance sheet. If Barings went under, the cash was gone. Unfortunately, this was a big number for a lot of people. One scheme we know stood to lose £3m in cash, which had been held alongside a portfolio of equities of around £60-70m.

For a week, this uncertainty hung over all of the clients, until a deal was worked out with ING and the cash commitments were made good. For a week there, it looked like clients of Barings Asset Management might be in real trouble in relation to their cash.

After Barings was saved, there was a backlash in the industry to make sure this position never impacted us again. Consultants started working with trustees on their cash controls - and regardless of whether Barings was used, all wanted to learn from the mistakes of others. Investment managers developed policies on their use of bank accounts on behalf of clients and on overall limits for allocation to specific organisations. We worked with clients and their custodians to sweep free cash into Short Term Investment Funds (known as STIFs). In a nutshell, we did a lot of work on how to manage credit issues.

Nice story you might hopefully say – but what's the point? The point is that it is relatively likely that policies on cash management and exposure were created in 1995 – but did they survive? If they have, do you know what they say? Do you know what your current managers' policies are?

My guess is that in many cases the policies have been forgotten. This isn't as terrible as it might sound. It's been 13 years since Barings went under with no significant banking issues since.

It's a long time to remember something that hasn't been important since. The trouble is, for things like this, we need long memory, as whilst they don't happen often when they do they can be significant. What has happened to our collective memory?

This is a hard thing to maintain and has to be one of the primary purposes of governance. Any process for maintaining collective memory has to be coupled with training, as turnover in trustees and providers will make it hard to remember otherwise. How many of you were trustees of the same scheme in 1995? Looking across our client base, the answer is certainly very few proportionately.

Just as an aside – the collapse of Barings was effectively a governance failure. The management of Barings failed to ask questions of Nick Leeson's operation, as they believed he was making such significant profits (a third of the entire Barings' profits in one year, so they thought) that they didn't want to rock the boat. In fact, this was a governance failure. Bringing it full circle, we could also make a reasonable argument that, 13 years later, the failure of Lehman's is also a governance failure. In this instance, the Chairman and Chief Executive was also one of the largest individual (i.e. not institutional) shareholders. Could this be related to the fact that Lehman's wasn't sold to the Koreans for \$7 a share because Dick Fuld believed it was worth "\$13"? Who knows, but I predict governance weaknesses will come out as this story plays out.

The point of focus

Most pension scheme trustees are spending plenty of time governing their pension arrangements. The last thing trustees want is more things to do. Perhaps the question is not adding things to do, but rather working out what to prioritise.

Hot Topics – Remember to Focus

October 2009

A survey of FTSE 100 companies a few years ago by Don Young for the Performance and Reward Centre, asked Board members a number of questions about strategy and governance. One of the key findings was that over 80% of Boards felt that corporate performance failures resulted not from weak control structures but from weak strategy. The upshot was that, because the Board was spending so much time ticking boxes that it didn't have enough time to focus on strategy and thinking more widely about the future of the company. Arguably, proposed strategies did not receive sufficient challenge, and therefore failures that occurred tended to be strategic rather than control failures.

Is there something we can learn from this? I would argue that, while we can identify many things that are extremely important to consider, we are perhaps not spending sufficient time thinking about which issues we (as trustees) should focus on specifically.

The way some company boards are dealing with this is through exception reporting – the only issues that get considered, outside of strategy, are those where agreed metrics are breached and an issue is flagged. This is particularly true of investment monitoring.

I am sure we all spend significant amounts of time reviewing investment performance, asset allocations etc, along with interviewing managers. Is this the best use of our time?

If we spend an hour or two per quarter on this issue, wouldn't it make more sense to focus only on those issues that are in some way unexpected, and accept that the remainder fall within our expectations. Releasing extra time could be valuable in focusing on strategic issues.

In our investment monitoring, we have moved towards exception reporting, but we suspect there is more to do and hence you should expect to see some changes to this effect in your quarterly governance report. To get the most out of exception reporting, we need to think more generally about what governance represents.

The four dimensions of governance

In simple terms, governance is about four things.

Firstly, strategy. On the investment side, this is about the allocation to assets, how these change through time, and what sorts of management arrangements to use.

In relation to the liabilities, this is about funding and certain benefit decisions. It is about how to measure performance. These are arguably the biggest decisions, with a significant impact on whether the pension scheme succeeds. As a wise man once said, get the strategy right and you can have execution slippage. Get the strategy wrong, execution must be perfect and then some....

Second is people. People is about execution of the strategy. It's about how the functions are organised – by use of service providers and composition of the trustee board itself. It is about the relationship with the service providers. One of our clients had a reasonably long standing Chairman who retired a few years ago. In his departing speech, he made the point that his one regret was that they "didn't act quickly enough" to deal with performance issues on managers. The remaining trustees who were there at the time still remember this, and have held true to this philosophy since. It has added a lot of value. Acting to ensure the right people work for you is key.

Risk management is what most people think when governance comes up. It is the controls around a wide range of issues to minimise risks that will emerge from time to time. Generally, these relate to downside only risks, such as the cash risks I talked about right at the beginning. There is a wide range, and these are arguably dealt with best on an exceptions basis, as otherwise they will dominate discussion.

Finally, there is communication and engagement. In one sense, it doesn't matter how good a job you're doing if none of the stakeholders know it.

Communication involves certain things that have to be done – SIPs, accounts etc – and certain things that we may choose to do – such as regular communication with the sponsor to pass on "your story".

However, it is worth thinking in this process about what you actually want to say as your message, and try and make all your communication consistent with this. Ultimately, if a scheme is well governed, this is the opportunity to show the world that fact.

The reason why we suggest you think about governance in these terms is this. Next time you're in a trustee meeting, work out how much time is spent on each of these issues. Historically I'd guess that, other than administration issues, much of the discussion will be around risk management and performance of providers (mainly investment managers).

Hot Topics – Remember to Focus

October 2009

Ideally, we should be spending more time on bigger questions.

There are some very current issues on this now. At the 2009 P-Solve investment conference, the P-Solve CEO, Mike Faulkner, talked about a number of potentially important future trends that you could – if you act – prepare yourselves for in advance. These include increasing allocations to emerging markets and engaging with more illiquid investments. Fuller consideration of these issues requires making time.

Summary

If the totality of governance is about ticking boxes, not only will it be mind-numbingly boring, it probably won't be effective. Not least because it will take time from bigger issues that arguably would have a bigger impact on the success of the scheme.

At the same time, we also need to find a way to retain our memory, so that the work we did last time a problem arose isn't lost when it's needed again.

Understanding that governance covers four areas I hope should help. If you need to remember the areas, think of it as SPRuCE-ing your scheme – S for strategy, P for people, R for Risk, C and E for communication and engagement with your stakeholders, and in the middle of it all is “u”, the trustees. Trite, but hopefully it'll work!

In summary, I have a very simple message - think of the SPRuCE tool as a way of managing the time spent on each area. If you need to manage down the time in a particular area (probably risk) then think about using exception reporting. Consider using the extra time to think about the strategic issues, so we can be prepared better. And finally, let's remember to work on our memory. If we achieve that I think we'll have taken governance a long way.



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Datasource: Data has been sourced from the Performance Measurer, Managers and Datastream.

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