London Borough of Hammersmith & Fulham Pension Fund

Investment Governance Report – Quarter 1 2011

May 2011

CAMRADATA
Pension Reporting

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

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.

Breakdown of Scheme Peformance by Manager as at 31st March 2011							
Fund	Manager	Market Value (£000)	% of Total Fund	Target % of Total Fund	3 month return (%)	1 year return (%)	3 year return (%)
Total Fund		**583,165**	**100.0**	**100.0**	**0.1**	**6.5**	**8.8**
Liability Benchmark + 1.75% p.a.					*0.2*	*8.6*	*2.1*
Difference					*(0.1)*	*(2.1)*	*6.7*
UK Equities		**155,429**	**26.7**	**25.0**			
	Majedie				1.6	8.6	10.1
FTSE All Share + 2% p.a.					*1.5*	*10.9*	*7.5*
Difference					*0.1*	*(2.3)*	*2.6*
Overseas Equities		**156,583**	**26.9**	**25.0**			
	MFS				0.0	6.7	11.0
FTSE World ex UK + 2% p.a.					*1.2*	*7.7*	*10.0*
Difference					*(1.2)*	*(1.0)*	*1.0*
Dynamic Asset Allocation Mandates		**146,646**	**25.1**	**25.0**	**0.0**	**7.0**	-
	Barings (note 2)	108,900	18.7	18.8	0.2	6.7	-
3 month Sterling LIBOR + 4% p.a.					*1.2*	*4.8*	-
Difference					*(1.0)*	*1.9*	-
	Ruffer (note 2)	37,746	6.5	6.2	*(0.6)*	*8.2*	-
3 month Sterling LIBOR + 4% p.a.					*1.2*	*4.8*	-
Difference					*(1.8)*	*3.4*	-
Matching Fund		**122,756**	**21.0**	**25.0**	**(1.3)**	**2.9**	-
Liability Benchmark + 1% p.a.					*(0.0)*	*7.8*	-
Difference					*(1.3)*	*(4.9)*	-
	Goldman Sachs	59,262	10.2	12.5	0.2	2.0	0.9
3 month Sterling LIBOR + 2% p.a.					*0.7*	*2.8*	*(0.7)*
Difference					*(0.5)*	*(0.8)*	*1.6*
	Legal & General (note 3)	63,494	10.9	12.5	*(2.7)*	3.8	3.9
2 x FTSE + 15yr IL Gilts - LIBOR p.a.					*(3.3)*	*9.2*	*0.5*
Difference					*0.6*	*(5.4)*	*3.4*
Cash		**1,751**	**0.3**	**0.0**			
	Cash				0.0	-	-

Notes:

1) All numbers are sourced from the Custodian, Northern Trust, and have not been independently verified. Figures may be affected by rounding.
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 Legal & General 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 Legal & General’s previous holdings.

Asset Reconciliation and Valuation

Asset Reconciliation and Valuation										
Fund	**Manager**	**Closing Market Value as at 31st December 2010 £000**	**% of Total Fund**	**Net Investment £000**	**Appreciation £000**	**Income Received £000**	**Fees £000**	**Closing Market Value as at 31st March 2011 £000**	**% of Total Fund**	**Target % of Total Fund**
Total Fund		**582,668**	**100**	**(319)**	**(1,268)**	**2,083**	**69**	**583,165**	**99.7**	**100.0**
UK Equities	**Majedie**	**154,028**	**26.4**	**(1,000)**	**1,074**	**1,327**	**-**	**155,429**	**26.7**	**25.0**
Overseas Equities	**MFS**	**157,600**	**27.0**	**(1,069)**	**(486)**	**538**	**69**	**156,583**	**26.9**	**25.0**
Dynamic Asset Allocation Mandates		**146,636**	**25.2**	**-**	**(205)**	**215**	**-**	**146,646**	**25.1**	**25.0**
	Barings	108,658	18.6	-	215	27	-	108,900	18.7	18.75
	Ruffer	37,978	6.5	-	(420)	188	-	37,746	6.5	6.25
Matching Fund		**124,404**	**21.4**	**-**	**(1,650)**	**2**	**-**	**122,756**	**21.0**	**25.0**
	Goldman Sachs	59,157	10.2	-	105	0	-	59,262	10.2	12.5
	Legal & General	65,247	11.2	-	(1,755)	2	-	63,494	10.9	12.5
Cash		**-**	**-**	**1,750**	**-**	**1**	**-**	**1,751**	**0.3**	**0.0**

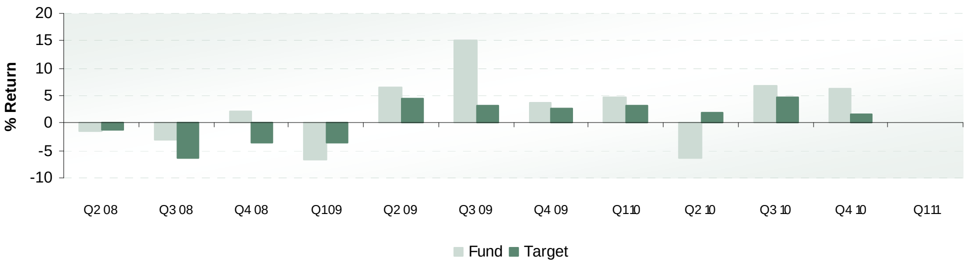
Notes: All numbers are sourced from the Custodian, Northern Trust, and have not been independently verified. Figures may be affected by rounding.

Historical Plan Performance

	Three Months	One Year	Three Years	Five Years	Inception To Date
Fund	0.14	6.45	8.83	6.28	3.64
Target	0.17	8.63	2.14	176	149

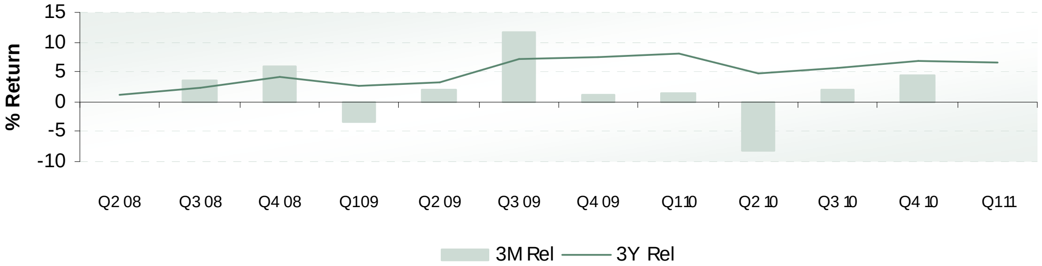
The Fund performed broadly in line with its liability benchmark over the quarter, returning 0.1% compared to the target of 0.2%. The relative underperformance was driven, in the main, by difficult conditions over the quarter across most asset classes, particularly sovereign fixed income. The Fund's performance of 6.5% over the year was below it's target by 2.2%, as it was affected by the poor equity markets in the second quarter of 2010. Overall the Fund has performed well on a 3 and 5 year basis.

Three Years Rolling Quarterly Returns



	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
Fund	-139	-3.11	2.03	-6.68	6.46	15.21	3.59	4.75	-6.34	6.87	6.20	0.14
Target	-123	-6.35	-3.61	-3.50	4.47	3.09	2.57	3.21	2.00	4.68	157	0.17

Three Years Rolling Relative Returns



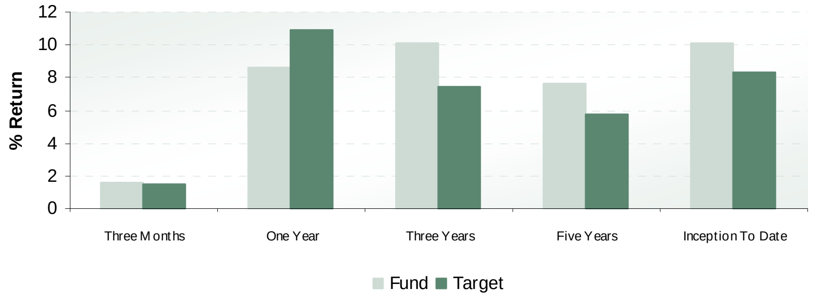
	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
3M Rel	-0.16	3.45	5.85	-3.29	190	1176	100	149	-8.18	2.09	4.56	-0.03
3Y Rel	103	2.21	4.13	2.79	3.37	7.14	7.52	8.10	4.86	5.57	6.83	6.55

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

Majedie

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 an OJEU tender process. They started managing investments for the fund in August 2005.

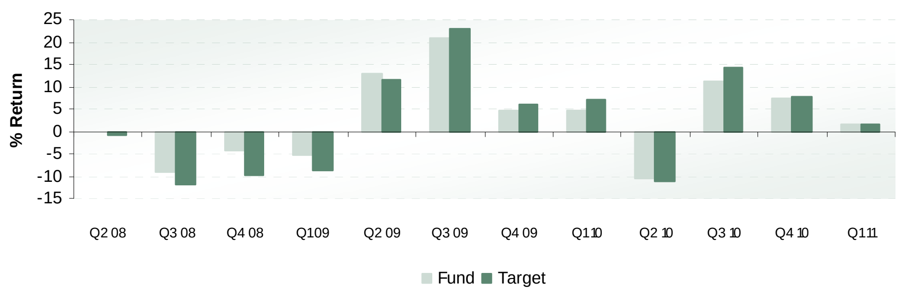
Historical Plan Performance



	Three Months	One Year	Three Years	Five Years	Inception To Date
Fund	156	8.63	10.12	7.61	10.08
Target	153	10.88	7.46	5.77	8.30

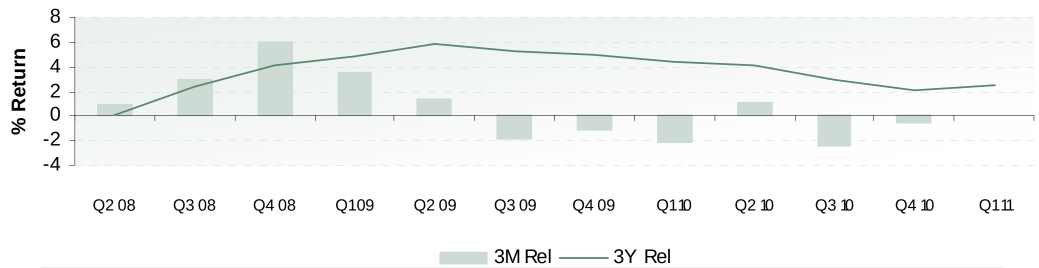
Quarterly Manager update	
Organisation	No significant changes over the quarter.
Product	No significant changes over the quarter.
Performance	The fund performance was 1.6% over the quarter, in line with its target. Over 12 months, the portfolio was 2.3% below its target. The portfolio's positions in large cap multinationals, such as Vodafone, which offer strong balance sheets, decent yields, trading on low valuations with low expectations, were helpful over the quarter, as was the negative stance on the Banking sector. The long position on Pfizer, which had a strong quarter on the back of reduced R&D spending, and short position on Associated British Foods also aided performance. The long position on Nokia, who continue to struggle in an increasingly competitive mobile phone market, and 3i, tripped up by a weak UK economy over the quarter despite a recent recovery, were detrimental to overall performance.
Process	No significant changes over the quarter.

Three Years Rolling Quarterly Returns



	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
Fund	0.00	-9.13	-4.38	-5.47	12.97	20.72	4.80	4.73	-10.47	11.36	7.29	156
Target	-0.96	-11.75	-9.74	-8.63	11.43	22.94	5.99	6.93	-11.35	14.17	7.90	153

Three Years Rolling Relative Returns



	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
3M Rel	0.96	2.96	5.94	3.46	138	-181	-112	-2.06	0.99	-2.46	-0.57	0.03
3Y Rel	-	2.38	4.13	4.88	5.82	5.27	4.96	4.35	4.11	2.93	2.11	2.48

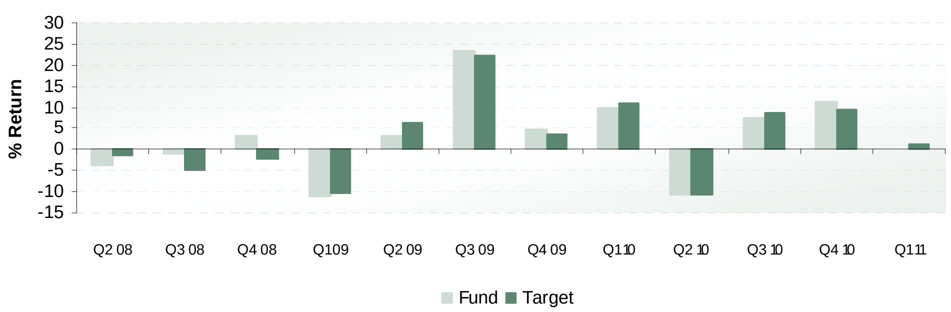
Notes: All numbers are sourced from the Custodian, Northern Trust, and have not been independently verified.

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 an OJEU tender process. They started managing investments for the fund in August 2005.

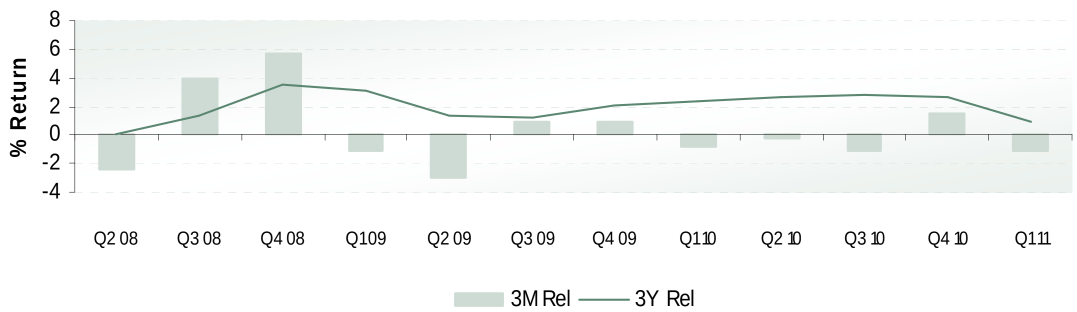
	Three Months	One Year	Three Years	Five Years	Inception To Date
Fund	0.04	6.65	10.96	8.04	10.43
Target	1.16	7.72	9.97	6.78	9.52

Quarterly Manager update

Organisation	No significant changes over the quarter.
Product	No significant changes over the quarter.
Performance	The performance was flat over the quarter, 1.1% behind its target. Over 12 months, the fund was 1.1% behind its target. Stock selection in basic materials, industrial goods & services and energy aided performance as did individual stock holdings in Accenture, Autodesk and not owning Microsoft. Stock selection in health care and special products & services as well as stock selection and overweight positions in financial services, consumer staples and retailing was detrimental to performance. Individual holdings of Acer, Cisco, Tawain Semiconductor and Konica Minolta also detracted from performance over the quarter.
Process	No significant changes over the quarter.



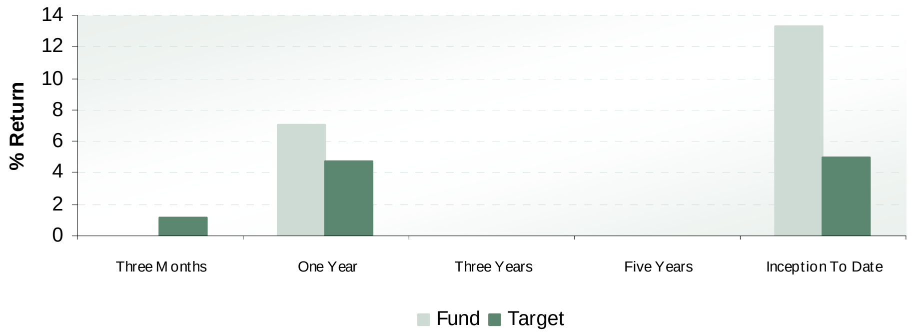
	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
Fund	-3.72	-1.02	3.29	-11.21	3.23	23.43	4.74	9.83	-10.85	7.54	11.19	0.04
Target	-1.27	-4.76	-2.22	-10.25	6.44	22.30	3.73	10.80	-10.65	8.77	9.57	1.16



	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
3M Rel	-2.48	3.93	5.64	-1.07	-3.02	0.92	0.98	-0.87	-0.22	-1.13	1.48	-1.11
3Y Rel	-	1.32	3.50	3.02	1.32	1.21	2.11	2.39	2.71	2.76	2.59	0.90

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

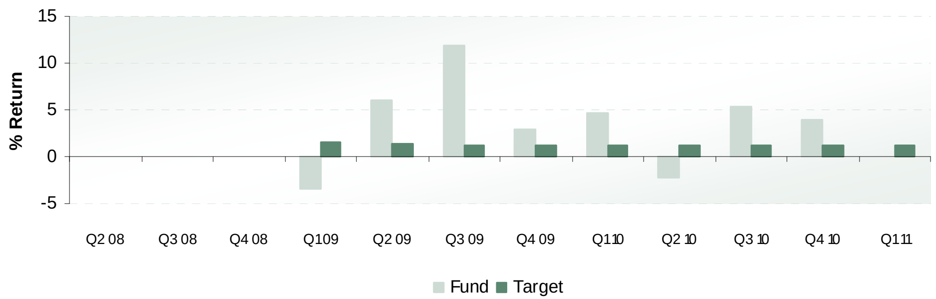
Historical Plan Performance



	Three Months	One Year	Three Years	Five Years	Inception To Date
Fund	0.01	7.04	-	-	13.26
Target	1.18	4.77	-	-	4.97

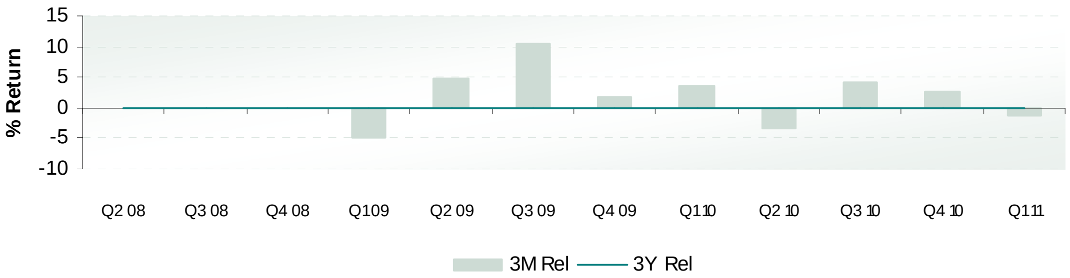
The performance of the group was flat over the quarter, the LIBOR-based target returned 1.2%, both Ruffer and Barings underperformed the target. The performance was primarily hindered by the equity holdings, as a result of stock selection in the case of Barings and exposure to Japan in the Ruffer portfolio. Over the past 12 months, performance has been 7.0% above target, as both managers (particularly Ruffer) have outperformed the target.

Three Years Rolling Quarterly Returns



	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
Fund	-	-	-	-3.38	6.10	11.82	2.99	4.73	-2.22	5.32	3.94	0.01
Target	-	-	-	1.50	1.33	1.19	1.14	1.14	1.16	1.17	1.17	1.18

Three Years Rolling Relative Returns



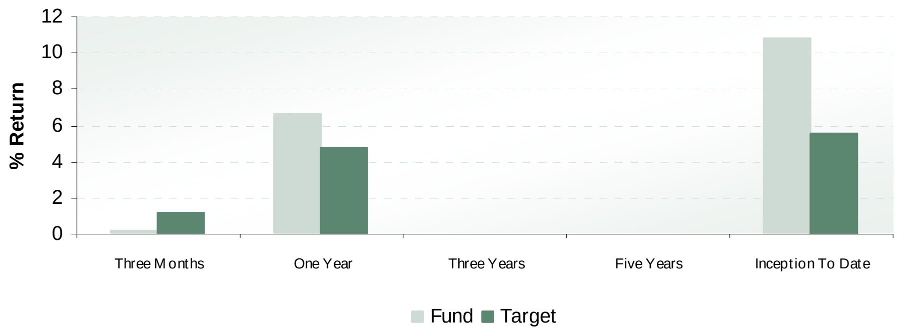
	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
3M Rel	-	-	-	-4.81	4.71	10.51	1.83	3.54	-3.34	4.10	2.74	-1.16
3Y Rel	-	-	-	-	-	-	-	-	-	-	-	-

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

Barings

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 an OJEU tender process. They started managing investments for the fund in August 2008.

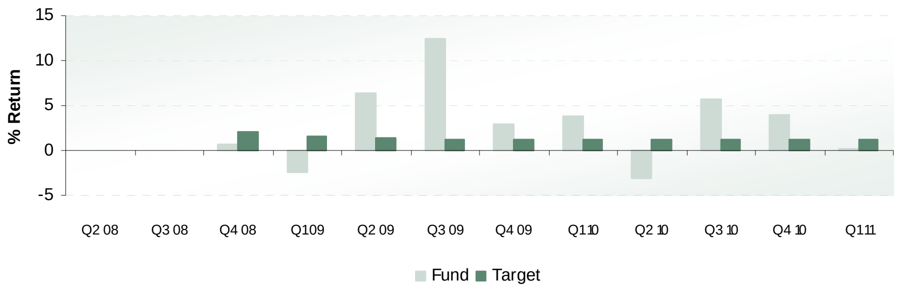
Historical Plan Performance



	Three Months	One Year	Three Years	Five Years	Inception To Date
Fund	0.22	6.65	-	-	10.78
Target	1.18	4.77	-	-	5.58

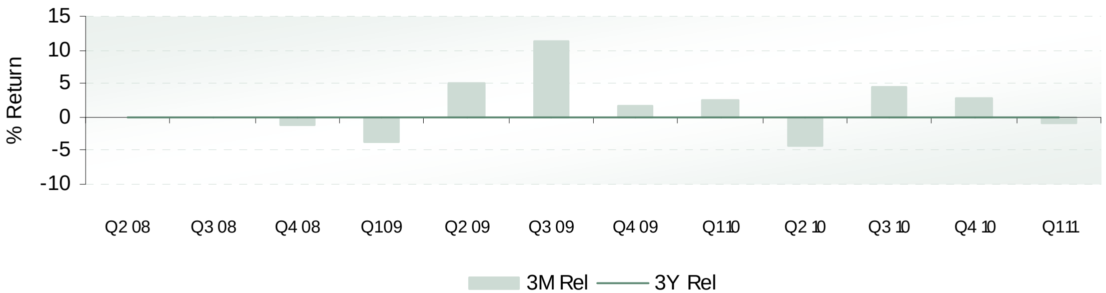
Quarterly Manager update	
Organisation	No significant changes over the quarter.
Product	No significant changes over the quarter.
Performance	The fund performance was 0.2% over the quarter, 1.0% behind its target. Over 12 months, the fund is 1.9% ahead of target. Stock selection was below the market in both the UK and globally, although the portfolio had already limited its exposure to Japan avoiding the losses caused as a result of the earthquake. Gold detracted slightly over the quarter, as did the hedging instrument which finished down 8%. The portfolio faired better in the bond market with Australian, UK corporate and international convertible bonds performing well even though government bonds generally recorded losses over the period. Commercial property also did well.
Process	No significant changes over the quarter.

Three Years Rolling Quarterly Returns



	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
Fund	-	-	0.67	-2.42	6.42	12.50	2.94	3.77	-3.12	5.73	3.88	0.22
Target	-	-	2.01	1.50	1.33	1.19	1.14	1.14	1.16	1.17	1.17	1.18

Three Years Rolling Relative Returns



	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
3M Rel	-	-	-1.32	-3.86	5.02	11.18	1.78	2.59	-4.23	4.51	2.68	-0.95
3Y Rel	-	-	-	-	-	-	-	-	-	-	-	-

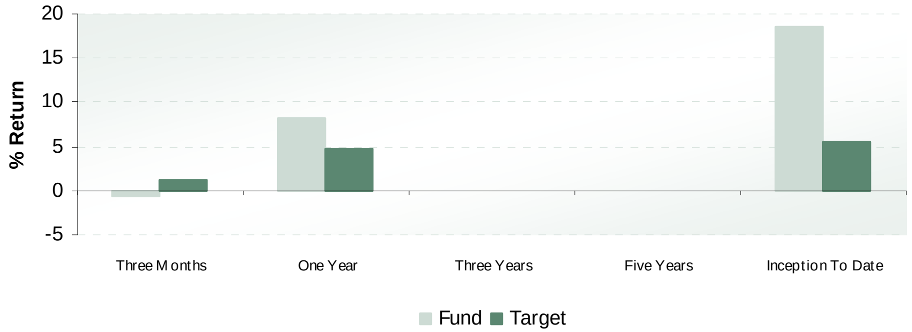
Notes: All numbers are sourced from the Custodian, Northern Trust, and have not been independently verified

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 an OJEU tender process. They started managing investments for the fund in August 2008.

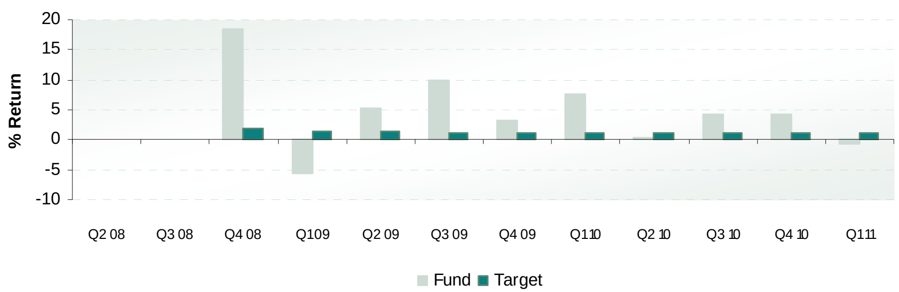
Quarterly Manager update	
Organisation	No significant changes over the quarter.
Product	No significant changes over the quarter.
Performance	The fund performance was -0.6% over the quarter, 1.8% behind its target. Over 12 months, the fund was 3.4% ahead of target. The portfolio's exposure to the Japanese markets, which fell sharply following the earthquake, holdings in gold and US dollar exposure hindered performance over the quarter. However, the portfolio's decision to initiate a position in long-dated US TIPS and hedge it's Yen exposure along with it's UK and global stock selection, especially SAP and ITV, did help to recover some ground.
Process	No significant changes over the quarter.

Historical Plan Performance



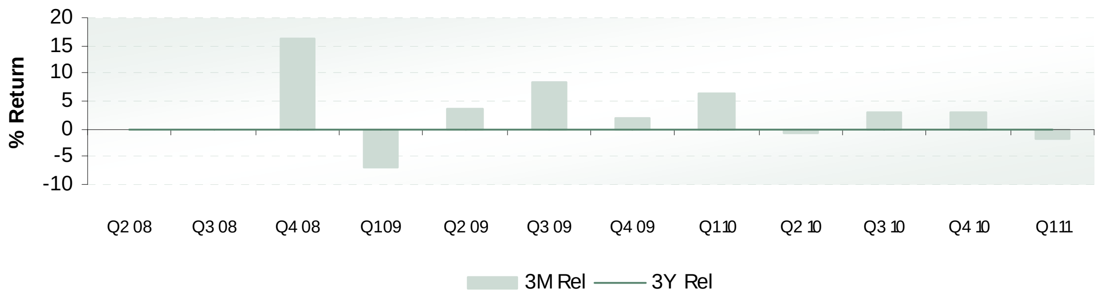
	Three Months	One Year	Three Years	Five Years	Inception To Date
Fund	-0.61	8.19	-	-	18.60
Target	1.18	4.77	-	-	5.58

Three Years Rolling Quarterly Returns



	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
Fund	-	-	18.47	-5.49	5.17	9.81	3.12	7.64	0.41	4.13	4.11	-0.61
Target	-	-	2.01	1.50	1.33	1.19	1.14	1.14	1.16	1.17	1.17	1.18

Three Years Rolling Relative Returns

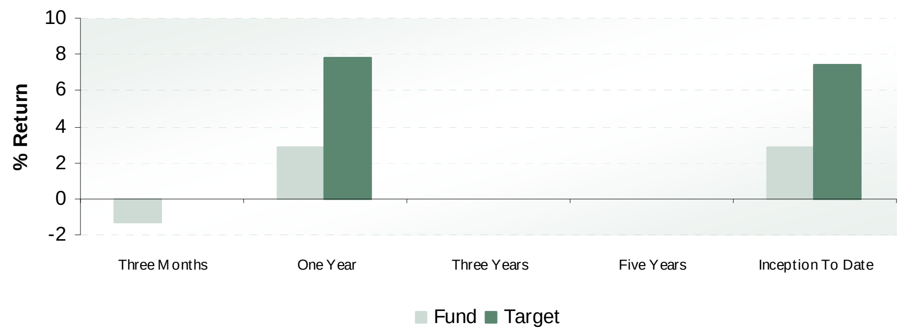


	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
3M Rel	-	-	16.14	-6.90	3.79	8.52	1.96	6.42	-0.74	2.93	2.91	-1.77
3Y Rel	-	-	-	-	-	-	-	-	-	-	-	-

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

Matching Fund

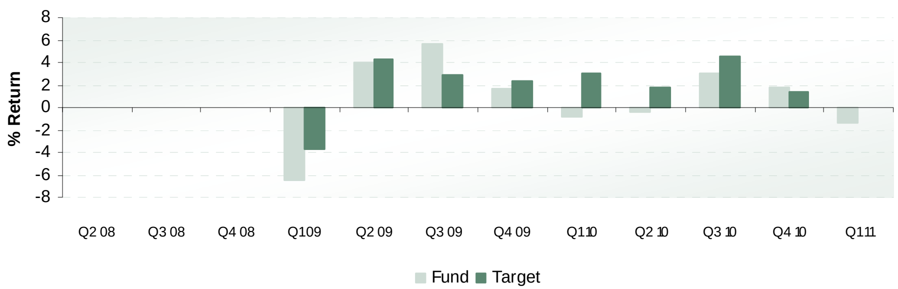
Historical Plan Performance



The performance of the Matching Fund over the quarter of -1.3% is 1.3% below its gilts-based liability benchmark. This can be attributed mainly to the adverse impact over the quarter of the negative returns from the LGIM Index-Linked portfolio (despite outperforming it's target) combined with underperformance against target from Goldman Sachs . The Matching Fund return of 2.9% over the year was 4.9% below target due to the relative underperformance of both mandates.

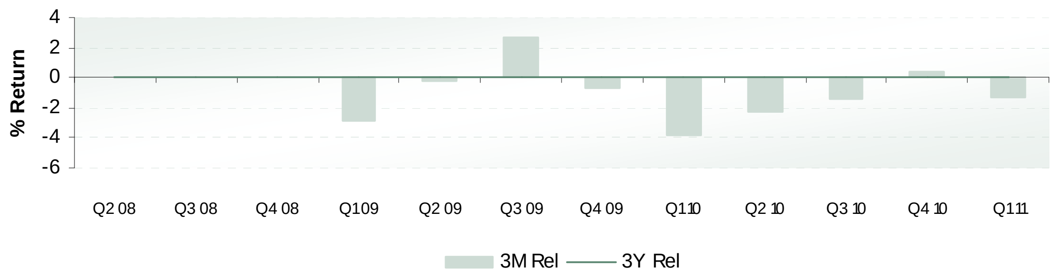
	Three Months	One Year	Three Years	Five Years	Inception To Date
Fund	-132	2.90	-	-	2.90
Target	-0.01	7.84	-	-	7.45

Three Years Rolling Quarterly Returns



	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
Fund	-	-	-	-6.45	4.04	5.66	167	-0.88	-0.48	2.98	175	-132
Target	-	-	-	-3.68	4.28	2.90	2.38	3.02	181	4.49	138	-0.01

Three Years Rolling Relative Returns



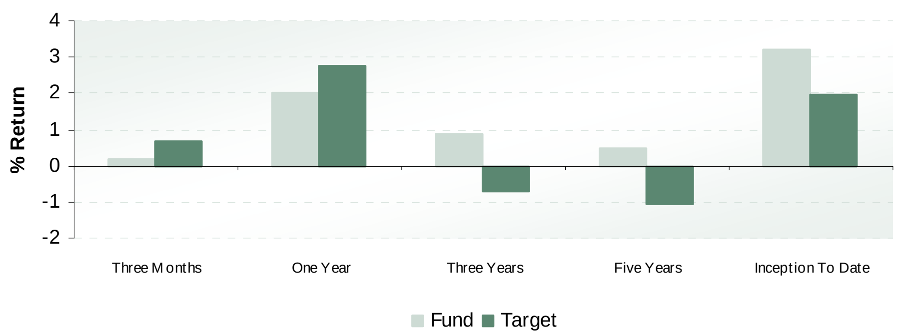
	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
3M Rel	-	-	-	-2.87	-0.23	2.68	-0.69	-3.79	-2.25	-145	0.36	-131
3Y Rel	-	-	-	-	-	-	-	-	-	-	-	-

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

Goldman Sachs

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 February 2009 manage an active bond fund.

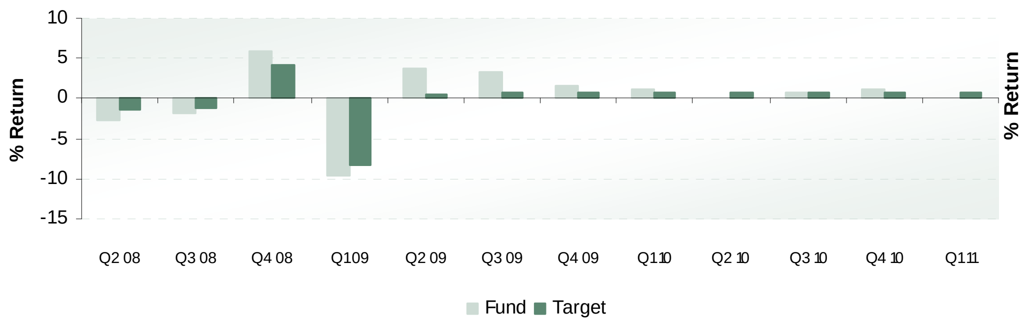
Historical Plan Performance



	Three Months	One Year	Three Years	Five Years	Inception To Date
Fund	0.18	2.00	0.89	0.50	3.21
Target	0.69	2.76	-0.70	-107	196

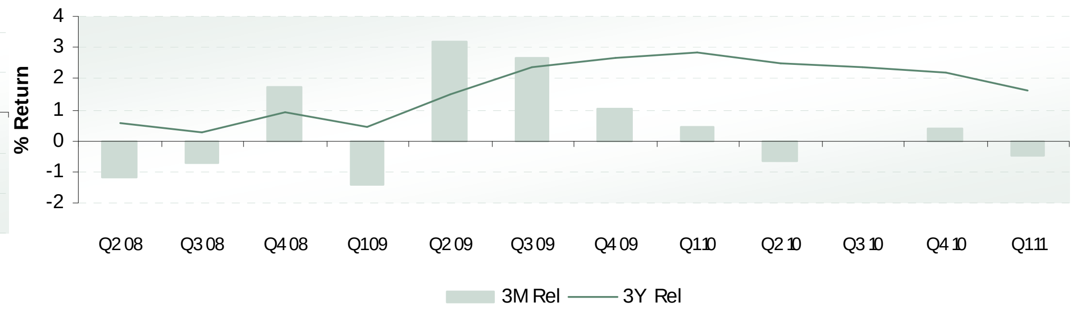
Quarterly Manager update	
Organisation	No significant changes over the quarter.
Product	No significant changes over the quarter.
Performance	The fund performance was 0.2% over the quarter, 0.5% behind its target. Over 12 months, performance was 0.8% below the target. The fund's country and EMD strategies hindered performance. However this was in part offset by the funds cross-sector strategy.
Process	No significant changes over the quarter.

Three Years Rolling Quarterly Returns



	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
Fund	-2.67	-186	5.86	-9.70	3.78	3.36	166	110	0.03	0.68	110	0.18
Target	-148	-112	4.09	-8.39	0.56	0.70	0.65	0.65	0.67	0.68	0.68	0.69

Three Years Rolling Relative Returns

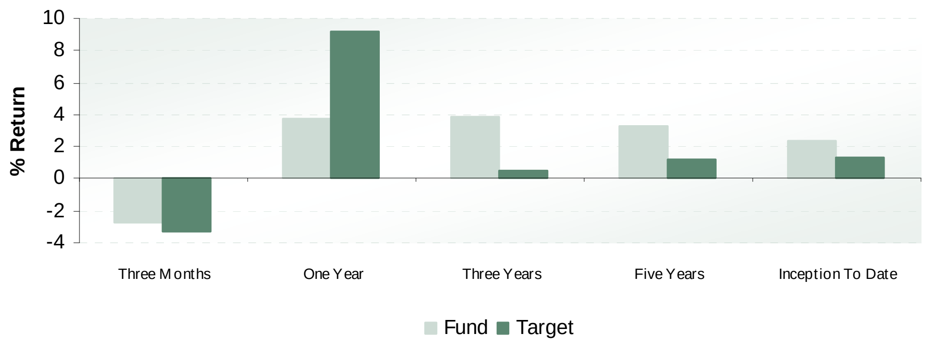


	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
3M Rel	-121	-0.74	170	-143	3.20	2.64	101	0.44	-0.64	0.00	0.42	-0.51
3Y Rel	0.54	0.27	0.90	0.47	148	2.37	2.68	2.86	2.51	2.37	2.19	160

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

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 an indexed basis. Their current investment mandate started in July 2009 following the investment structure review.

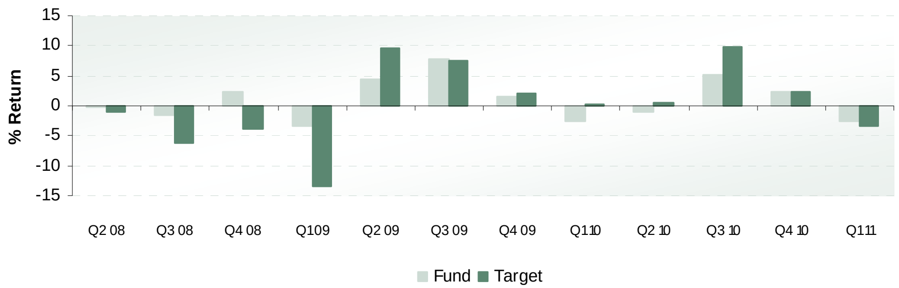
Historical Plan Performance



	Three Months	One Year	Three Years	Five Years	Inception To Date
Fund	-2.69	3.75	3.92	3.28	2.41
Target	-3.30	9.21	0.53	121	137

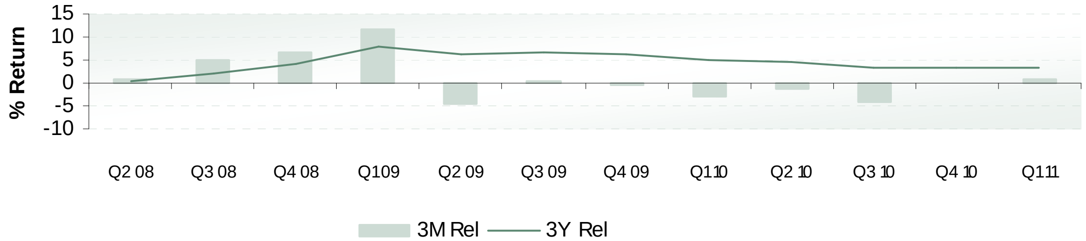
Quarterly Manager update	
Organisation	LGIM has appointed Mark Zinkula, its head in North America, as its new chief executive, a year after former chief Peter Chambers announced his decision to retire.
Product	No significant changes over the quarter.
Performance	The fund performance was -2.69% over the quarter, 0.6% ahead of its target. Over 12 months, performance is 5.5% behind target. The fund, which is invested in the 2055 Index-Linked Gilt, has again tracked its market benchmark over the quarter and has continued to track its market benchmark since inception.
Process	No significant changes over the quarter.

Three Years Rolling Quarterly Returns



	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
Fund	-0.17	-160	2.34	-3.32	4.29	7.85	168	-2.69	-0.96	5.18	2.34	-2.69
Target	-0.99	-6.25	-3.90	-13.51	9.52	7.48	2.08	0.36	0.39	9.89	2.38	-3.30

Three Years Rolling Relative Returns



	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11
3M Rel	0.83	4.97	6.49	11.78	-4.77	0.34	-0.40	-3.03	-134	-4.29	-0.04	0.63
3Y Rel	0.42	2.03	4.16	8.07	6.34	6.46	6.29	5.20	4.71	3.23	3.22	3.37

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

Market Performance

Despite the uncertainty at the start of the year, equity markets have finished the first quarter on a positive note. In sterling terms, UK and Global equities produced positive returns of 1% and 2% respectively. This, however, masked some wide variation in performance during the period and between markets.

United Kingdom Government bonds, meanwhile, produced a negative return over the period of -0.8% with longer dated bonds in particular falling back due to concerns over higher interest rates. UK Corporate Bonds, however, delivered a positive total return of 1% as the credit spread continued to fall.

Economic and Market Developments

Equities started the quarter positively with markets moving ahead in response to the perceived improvement in the economic outlook. However, the unexpected political turmoil in North Africa and the Middle East adversely impacted sentiment with the oil price rising significantly on concerns that the unrest could spread to Saudi Arabia, the world's largest oil producer, generating further upward pressure on the oil price.

Equity markets experienced further turbulence as the scale and destruction generated by the Japanese Tsunami became apparent to investors. Explosions at the Fukushima Daiichi nuclear plant, as water coolers failed, added to the difficulties faced by Japanese industry, with power supplies impacted and economic output lost.

Only now is the full economic impact being appreciated with Japan's March factory output having fallen by 15.3% month on month and household spending having declined by 8.5% annually. Against this backdrop, the Japanese market, which had initially fallen sharply, declined by 6.9% reflecting investors' assessment that the long term economic damage would be limited.

Elsewhere, the markets' focus centered on rising inflation, where global food and commodity prices have increased substantially, and economic growth with the Eurozone perhaps facing the most significant challenges. At its core, the German economy continued to perform strongly with economists predicting that the economy could grow by as much as 1% in the first quarter and by 3% over the year.

Germany's favourable outlook continues to be driven by the industrial sector, where orders grew by 2.4% in February after a 3.1% increase in January. However, there were encouraging signs that reliance on fast growing emerging markets was being reduced with domestic orders rising by 2.6%.

Despite the core Eurozone countries seeing continued expansion, the inevitable debt related strains resurfaced at the periphery, with Portugal now having to agree a €78 billion rescue package. The immediate market reaction however has been relatively sanguine and the European authorities must be hoping that Spain, seen by some as the next potential casualty, avoids a similar fate given that financial markets may be less accommodating.

Despite these tensions, the European Central Bank ('ECB') has been signalling higher interest rates in response to increasing inflationary pressure and in April, interest rates rose by 0.25% to 1.25%. With March inflation revised higher to 2.7% (up from 2.6%) against 2.4% for February, markets are expecting further rate rises with some suggesting perhaps as early as June.

Developed countries are not alone in facing inflationary pressures. China has been gradually tightening monetary policy via higher interest rates and by limiting credit creation to control inflation that reached 5.4% in March. These measures are expected to moderate economic growth to a still very respectable 9.4% for the quarter, but slightly lower than the growth of 9.8% achieved in the last quarter of 2010.

It is also significantly higher than the 1.8% growth achieved by the United States and clearly highlights the difference in performance between the world's two largest economies.

In the United Kingdom, the Bank of England also faces pressure to increase rates, but the economic backdrop remains uncertain and therefore is likely to be more cautious than the ECB.

Whilst the United Kingdom economy has recovered from the sharp and surprising decline seen at the end of last year with GDP growth rising 0.5%, the trend over both quarters is disappointing and will do little to reassure consumers who are seeing budgets squeezed by higher inflation and at the impact of Public Spending cutbacks. UK retailers in particular appear to be suffering with a number of companies including Dixons and Carpetright having recently announced profits warnings.

There are however, some grounds for optimism. Manufacturing activity remains strong and the March Purchasing Manager's Index for the service sector showed a strong bounce, which in part reflected a surge in Government spending ahead of the new fiscal year that will not be repeated over the coming months.

Outlook

Economists expect Global growth to be in the region of 3.5 to 4% for 2011 and with corporate earnings continuing to recover, profit margins remaining robust and healthy corporate balance sheets, equities have their supporters. However, economic recovery will remain sensitive to new developments and will inevitably face new challenges over the coming months in addition to the existing issues of higher inflation and an oil price that rose by over 20% during the last quarter.

Developments in China will be closely watched and any signs that their monetary tightening has overshot will unsettle investors, who have become accustomed to seeing strong economic growth.

In addition, at some stage, the accommodative monetary stance of the major central banks will be reversed thereby withdrawing the liquidity that was pumped into the system, as the authorities sought to contain the effects of the credit crunch. There are already signs of this with the Federal Reserve Bank's Quantitative Easing program, which has been applying downward pressure on yields, widely expected to cease in June and further interest rate rises expected by the ECB, although broad policy remains supportive.

Overview:

Given the unprecedented market conditions experienced of late and the associated illiquidity of certain assets previously regarded as being liquid, The Pensions Research Accounting Group (PRAG) have produced a paper "Guidance on Investment Valuations" for use by those responsible for preparing pension fund financial statements.

This aims to provide guidance as to how to apply the "Market" or "Fair Value" requirements of the Statement of Recommended Practice (SORP): Financial Reports of Pension Schemes (Revised May 2007) which was incorporated into the Financial Reporting Standard (FRS) 26.

Essentially the issue is the extent to which there may be exposure to an unrecognised "Valuation Risk" within a fund in that the valuations being assigned to the assets may not be a true reflection of the realisable value of those assets.

FRS 26 aimed at creating consistency in valuations reported by Pension Funds and the Corporate Reporting of the sponsoring company. This involved the introduction of the "fair value" concept, defined as "*the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction*".

This definition was also incorporated into the revised SORP (2.95), which gives guidance on the valuation of the principal categories of investment as follows:

- Quoted Securities – closing (last trade or bid price) of stock exchange on which they are quoted.
- Unquoted Securities – "fair value" as estimated by the Trustees, based on advice of the investment manager or appropriate professional adviser.
- Pooled Investment vehicles – closing price or if no bid price, "fair value".
- Properties – Valuation in accordance with RICS valuation standards
- Derivatives – Fair value in the net asset statement.

Detail:

The PRAG Guidance does not aim to address valuation methodologies, but says that those involved in preparing financial statements "*have to be satisfied that the valuations provided, comply with the investment valuation requirements of the SORP".* It does not expect that valuations should be audited, but that there is an appropriate framework in place to establish and ensure the valuations are provided on a fair basis.

The SORP does not touch on valuing illiquid investments, other than to say that if the market for an investment is not active, then an estimate can be established using (unspecified) valuation techniques.

The International Accounting Standards Board (IASB) Expert Advisory Panel has however addressed this issue by producing a paper *"Measuring and disclosing the fair value of financial instruments in markets which are no longer active"* (October 2008). It subsequently (2009) published an exposure draft on Fair Value Measurement ("The Exposure Draft") with the following objectives:

- Establish a single source of guidance for all fair value measurements
- Clarify the definition of fair value
- Enhance disclosure about fair value
- Increase convergence with US GAAP (Generally Accepted Accounting Principles)

The PRAG Guidance comments on what it describes as the three "Levels of Input" required for establishing fair value for an investment as defined in the IASB Exposure Draft. These are as follows:

Level 1 Inputs – represent quoted prices in an active market for identical assets that the entity can access at the measurement date, where "active market" is defined as ***"one in which transactions take place with sufficient frequency and volume to provide pricing information"***

Level 1 inputs are easy to price; there is a liquid market for these securities

Level 2 Inputs – reflect inputs observable directly (as prices) or indirectly (derived from prices). Level 2 inputs are moderately difficult to price; they have limited visible market parameters e.g. Swaps priced by reference to interest rate curves which are derived from observable market data.

Level 2 inputs can include:

- Quoted prices for similar assets in active markets.
- Quoted prices for identical assets in markets that are not active.
- Inputs other than quoted prices that are observable (interest rates, yield curves, volatilities).
- Inputs derived principally from, or corroborated by, market data.

Level 3 Inputs – refer to inputs that are not based on observable market data (unobservable inputs). Level 3 inputs are difficult to price; it is difficult to verify parameters used in their valuation e.g. private equity which uses information not available in the market.

The PRAG Guidance note goes on to say that Pension Funds using pooled vehicles may not be satisfied that considering pricing risks at a "unit" level provides an insight into the valuation risks in the underlying portfolio.

Consequently PRAG guidance is that the "look through" approach (where an assessment is made of the valuation basis of the underlying investments) is more useful to Fund accountants and Trustees when considering pricing risks within their investment portfolios. In many cases this will have the same effect as following the US guidance. It also acknowledges the fact that more guidance will be required on this point in the future.

PRAG recognises however that investment within a pooled vehicle may comprise different "Levels" of valuation categorisation. Importantly, (and perhaps in contradiction of the previous statement with regard to "look through"), in this event they say that the pricing of a pooled vehicle should be allocated to the pricing level which provides best fit to the predominant pricing characteristics of the underlying investments i.e. It is not split between pricing levels.

Implications for Trustees

Based on a reading of the PRAG Guidance note, the first thing to say is that the motivation for issuing this appears to be one of ensuring that Pension Accountants and more importantly Trustees are aware of any pricing risks, which are inherent in their portfolios. Pricing Risk equates to the possibility that the valuation attached to the asset is not a true reflection (fair value) of its actual worth.

It seems to be in the main advisory rather than prescriptive, however it does make the point that some pension funds (e.g. those reporting to US parents and those whose UK parent company has adopted fair value accounting under FRS 26) should address the issue of "fair pricing" and satisfy themselves as to the appropriate level being adopted by their managers.

Additionally, PRAG believe it to be likely that this will become a reporting requirement for all funds, given the planned convergence of International Accounting Standards and UK GAAP in 2012.

Summary

Setting aside the possible future requirement from an accounting perspective to reflect the fair value of investments, it is perhaps incumbent on Trustees from a Governance perspective to satisfy themselves that the valuations placed on their assets are deemed to be "fair value" and to be at least aware of any investments which (based on the "Levels" outlined in the PRAG guidance) may be held to be Level 3 valuations. That is, where the valuations are not based on any observable market data.

This could be achieved through investigation with the Fund's investment managers on a semi-regular basis and (as always from a governance perspective) documenting the results.

As with any other type of Investment Risk, Pricing Risk should if possible be identified and quantified as part of assessing the overall risk budget.

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Datasource: Data has been sourced from the Custodian, Northern Trust, and the Managers.