London Borough of Hammersmith & Fulham Pension Fund

Investment Governance Report – Quarter 2 2010

August 2010

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 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	*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 30th June 2010

Fund	Manager	Market Value (£000)	% of Total Fund	Target % of Total Fund	3 month return (%)	1 year return (%)	3 year return (%)
Total Fund		**512,753**	**100.0**	**100.0**	**(6.3)**	**17.1**	**3.3**
Liability Benchmark + 1.75% p.a.					*2.0*	*11.3*	*(1.5)*
Difference					*(8.3)*	*5.8*	*4.8*
UK Equities		**128,914**	**25.1**	**25.0**			
	Majedie				(10.5)	18.6	0.1
FTSE All Share + 2% p.a.					*(11.4)*	*23.5*	*(3.9)*
Difference					*0.9*	*(4.9)*	*4.0*
Overseas Equities		**131,846**	**25.7**	**25.0**			
	MFS				(10.9)	26.6	4.3
FTSE World ex UK + 2% p.a.					*(10.7)*	*25.6*	*1.6*
Difference					*(0.2)*	*1.0*	*2.7*
Dynamic Asset Allocation Mandates		**133,264**	**26.0**	**25.0**	**(2.2)**	**17.9**	
	Barings (note 2)	98,930	19.3	18.8	(3.1)	16.4	-
3 month Sterling LIBOR + 4% p.a.					*1.2*	*4.7*	-
Difference					*(4.3)*	*11.7*	-
	Ruffer (note 2)	34,334	6.7	6.2	0.4	*22.4*	-
3 month Sterling LIBOR + 4% p.a.					*1.2*	*4.7*	-
Difference					*(0.8)*	*17.7*	-
Matching Fund		**118,728**	**23.2**	**25.0**	**(0.5)**	**6.0**	
Liability Benchmark + 1% p.a.					*1.8*	*10.5*	-
Difference					*(2.3)*	*(4.5)*	-
	Goldman Sachs	58,116	11.3	12.5	0.0	6.3	1.4
3 month Sterling LIBOR + 2% p.a.					*0.7*	*2.7*	*(1.1)*
Difference					*(0.7)*	*3.6*	*2.5*
	Legal & General (note 3)	60,612	11.8	12.5	(1.0)	5.7	1.3
2 x FTSE + 15yr IL Gilts - LIBOR p.a.					*0.4*	*10.5*	*(3.3)*
Difference					*(1.4)*	*(4.8)*	*4.6*

Notes:

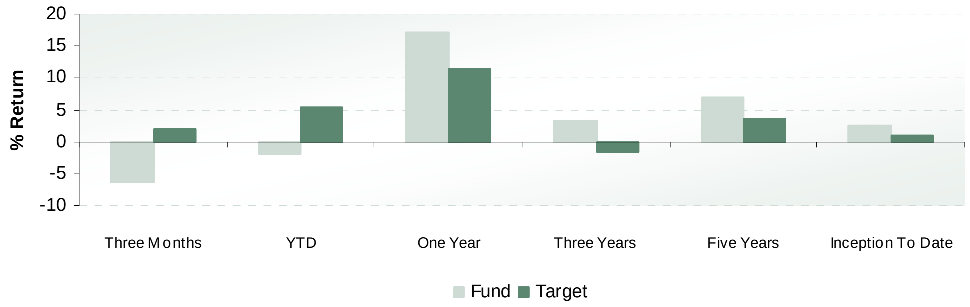
1) All numbers are sourced from the Custodian, Northern Trust, and have not been independently verified. Figures may be affected by rounding.
2) Performance for Ruffer and Barings is for less than 3 years. Date of inception for Ruffer is 7th August 2008. Date of inception for Barings is 19th August 2008.
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									
Fund	Manager	Opening Market Value as at 31st March 2010 £000	% of Total Fund	Net Investment £000	Appreciation £000	Income Received £000	Closing Market Value as at 30th June 2010 £000	% of Total Fund	Target % of Total Fund
Total Fund		**548,224**	**100.0**	**(732)**	**(37,985)**	**3,246**	**512,753**	**100.0**	**100.0**
UK Equities	**Majedie**	**143,998**	**26.3**	**-**	**(16,081)**	**997**	**128,914**	**25.1**	**25.0**
Overseas Equities	**MFS**	**147,894**	**27.0**	**-**	**(17,318)**	**1,270**	**131,846**	**25.7**	**25.0**
Dynamic Asset Allocation Mandates		**137,032**	**25.0**	**(732)**	**(4,014)**	**979**	**133,264**	**26.0**	**25.0**
	Barings	102,112	18.6	-	(3,206)	25	98,930	19.3	18.75
	Ruffer	34,920	6.4	**(732)**	(808)	954	34,334	6.7	6.25
Matching Fund		**119,299**	**21.8**	**-**	**(572)**	**1**	**118,728**	**23.2**	**25.0**
	Goldman Sachs	58,098	10.6	-	18	0	58,116	11.3	12.5
	Legal & General	61,201	11.2	-	(590)	1	60,612	11.8	12.5

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

Overall Performance

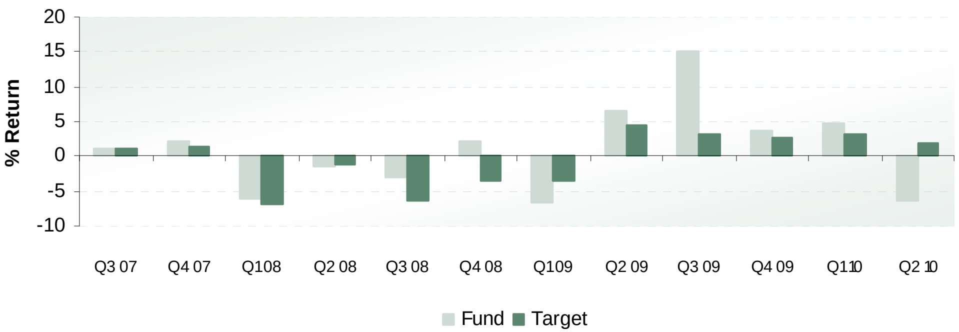
Historical Plan Performance



	Three Months	YTD	One Year	Three Years	Five Years	Inception To Date
Fund	-6.34	-189	17.10	3.25	6.94	2.65
Target	2.00	5.28	1132	-154	3.63	0.99

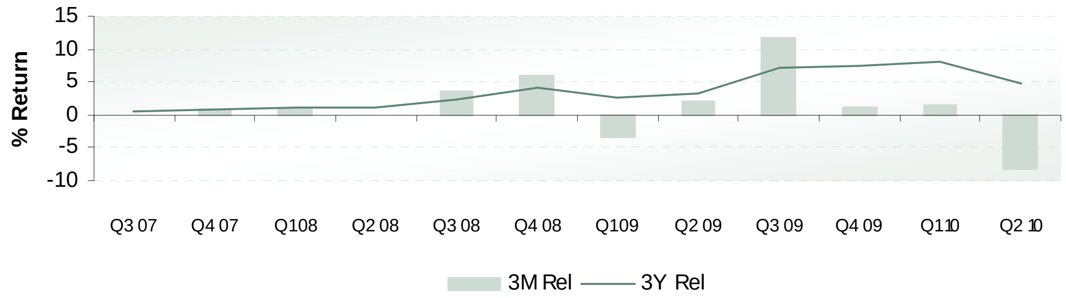
The Scheme underperformed against its liability benchmark over the quarter, returning -6.3% compared to the target of +2.0%. With the exception of the Ruffer DAA fund and Goldman Sachs bond fund, all mandates yielded negative returns over the quarter but the equity funds were the worst performers. There was again outperformance over the last 12 months, of 5.8%. The outperformance can primarily be attributed to the equity and DAA funds due to the strong rebound of equity markets over the year despite disappointing returns this quarter. Overall the Scheme has also performed well on a 3 and 5 year basis.

Three Years Rolling Quarterly Returns



	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
Fund	109	2.28	-6.13	-139	-3.11	2.03	-6.68	6.46	15.21	3.59	4.75	-6.34
Target	105	136	-6.85	-123	-6.35	-3.61	-3.50	4.47	3.09	2.57	3.21	2.00

Three Years Rolling Relative Returns



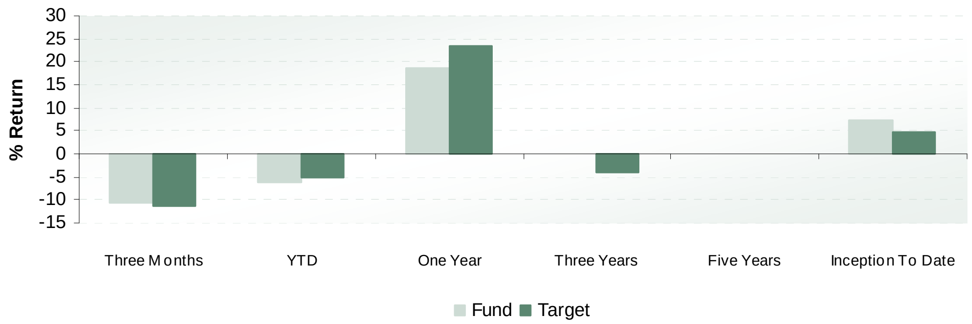
	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
3M Rel	0.04	0.91	0.78	-0.16	3.45	5.85	-3.29	190	11.76	100	149	-8.18
3Y Rel	0.58	0.95	108	103	2.21	4.13	2.79	3.37	7.14	7.52	8.10	4.86

Notes: All numbers are sourced from the Custodian, Northern Trust, and have not been independently verified. The historic figures for the three years rolling relative returns table differ from those shown in the Q3 report; Northern Trust have revised the historic figures since Q3.

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

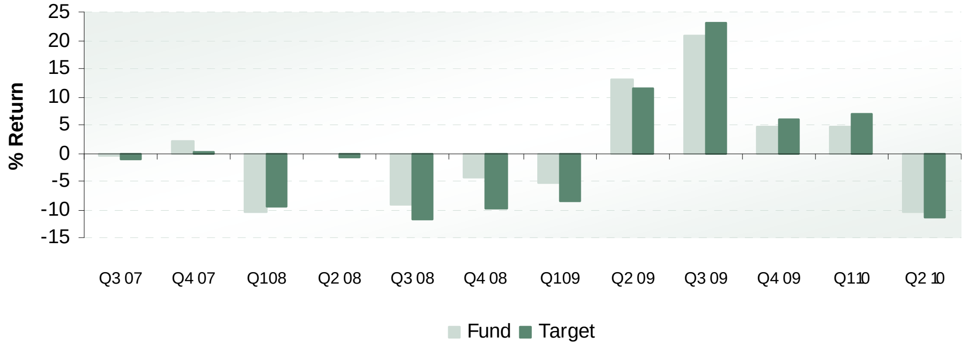


	Three Months	YTD	One Year	Three Years	Five Years	Inception To Date
Fund	-10.47	-6.24	18.62	0.09	-	7.35
Target	-11.35	-5.20	23.53	-3.86	-	4.69

Quarterly Manager update

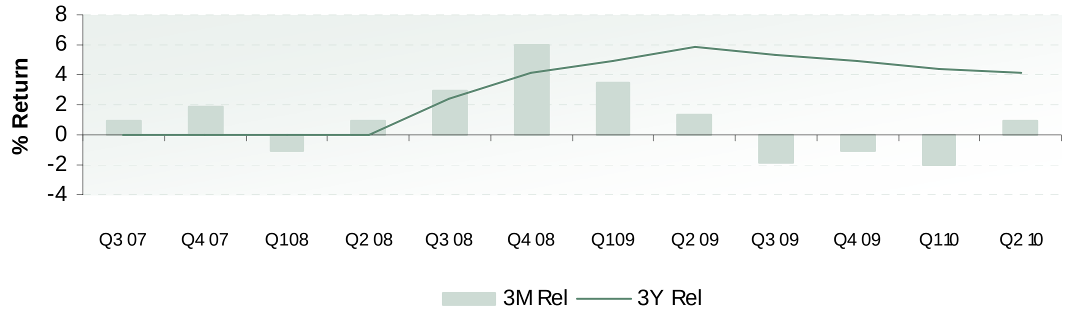
Organisation	No significant changes over the quarter.
Product	No significant changes over the quarter.
Performance	The fund performance was -10.5% over the quarter, 0.9% ahead of its target. Over 12 months, the portfolio was 4.9% below its target. The defensive characteristics of the portfolio benefited performance as risk appetite waned. The portfolio's holdings in defensive UK multinationals helped to limit losses as the wider index fell sharply. This cautious stance helped the portfolio outperform against its target over the quarter. However, the benefit of this defensive stance was limited by the impact of BP, a stock which the portfolio held for its characteristics of low valuation, a sound balance sheet and high quality assets.
Process	No significant changes over the quarter.

Three Years Rolling Quarterly Returns



	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
Fund	-0.38	2.03	-10.35	0.00	-9.13	-4.38	-5.47	12.97	20.72	4.80	4.73	-10.47
Target	-1.27	0.15	-9.41	-0.96	-11.75	-9.74	-8.63	11.43	22.94	5.99	6.93	-11.35

Three Years Rolling Relative Returns



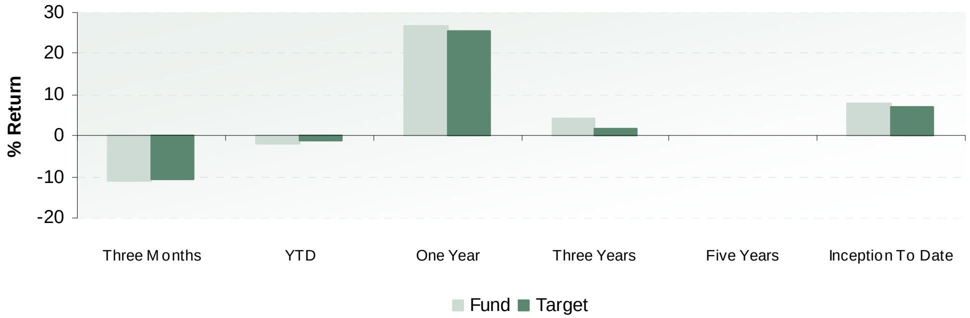
	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
3M Rel	0.91	1.88	-1.05	0.96	2.96	5.94	3.46	1.38	-1.81	-1.12	-2.06	0.98
3Y Rel	-	-	-	-	2.38	4.13	4.88	5.82	5.27	4.96	4.35	4.11

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

MFS

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.

Historical Plan Performance

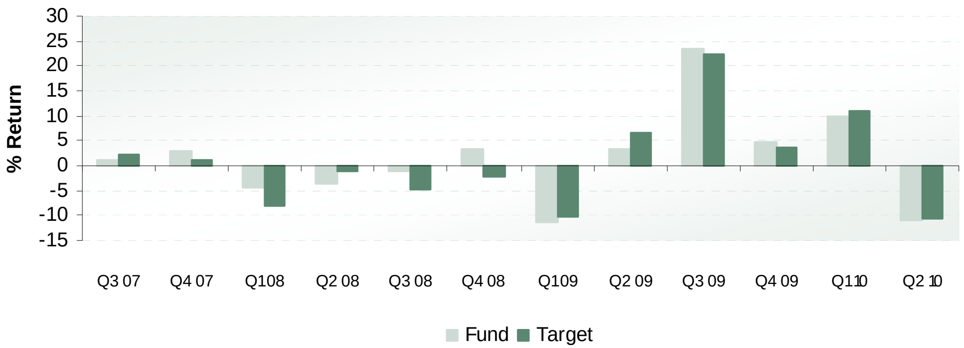


	Three Months	YTD	One Year	Three Years	Five Years	Inception To Date
Fund	-10.85	-2.08	26.59	4.30	-	8.07
Target	-10.65	-100	25.59	155	-	6.86

Quarterly Manager update

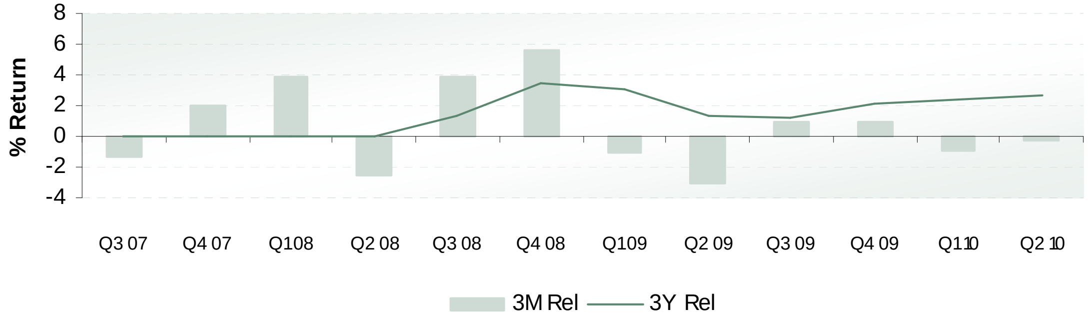
Organisation	During the quarter, MFS announced the appointment of Robert J Manning to chairman, effective 1 July 2010, succeeding Robert C Pozen, who has announced his plans to retire on 31 December 2011. Manning will continue in his role as CEO.
Product	No significant changes over the quarter.
Performance	The fund performance was -10.9% over the quarter, 0.2% below its target. Over 12 months, the fund was 1.0% ahead of its target. Currency effects were again adverse, due to the overweight to euro-denominated stocks as the euro depreciated relative to other currencies during the quarter. Stock selection in financial services, technology and utilities & communications as well as individual holdings in Walgreen, Inpex and Medtronic also detracted from performance. However, the overweight position and stock selection in consumer staples along with stock selection in basic materials, along with individual holdings in LVMH, Canadian National Railway, Waters Corp and Legrand added to the performance of the fund over the quarter.
Process	No significant changes over the quarter.

Three Years Rolling Quarterly Returns



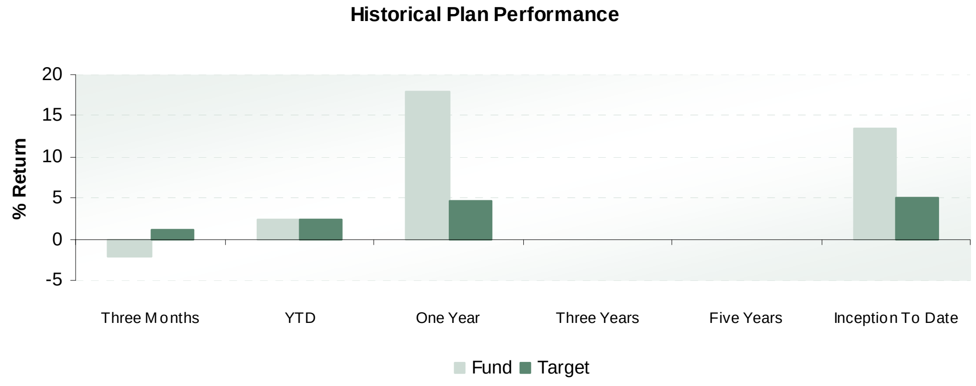
	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
Fund	0.99	2.95	-4.44	-3.72	-102	3.29	-11.21	3.23	23.43	4.74	9.83	-10.85
Target	2.28	0.94	-8.05	-127	-4.76	-2.22	-10.25	6.44	22.30	3.73	10.80	-10.65

Three Years Rolling Relative Returns



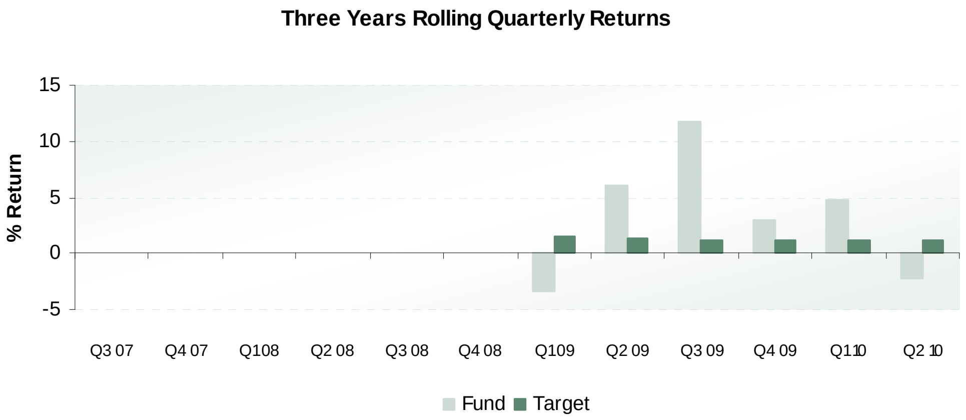
	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
3M Rel	-127	2.00	3.92	-2.48	3.93	5.64	-107	-3.02	0.92	0.98	-0.87	-0.22
3Y Rel	-	-	-	-	132	3.50	3.02	132	121	2.11	2.39	2.71

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

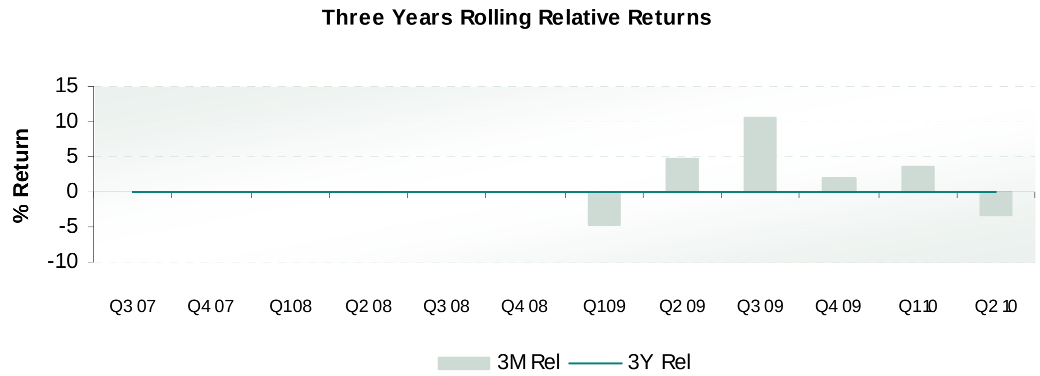


The group has returned -2.2% over the quarter compared to its LIBOR-based target of 1.2%, due to a weak performance from Barings in particular. The Dynamic Asset Allocation group in general has suffered from the poor performance from the equity components of their portfolios over the quarter. However, over the past 12 months, performance has been above target, as both Barings and Ruffer have significantly outperformed the target.

	Three Months	YTD	One Year	Three Years	Five Years	Inception To Date
Fund	-2.22	2.40	17.92	-	-	13.48
Target	1.16	2.31	4.71	-	-	5.07



	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
Fund	-	-	-	-	-	-	-3.38	6.10	11.82	2.99	4.73	-2.22
Target	-	-	-	-	-	-	1.50	1.33	1.19	1.14	1.14	1.16

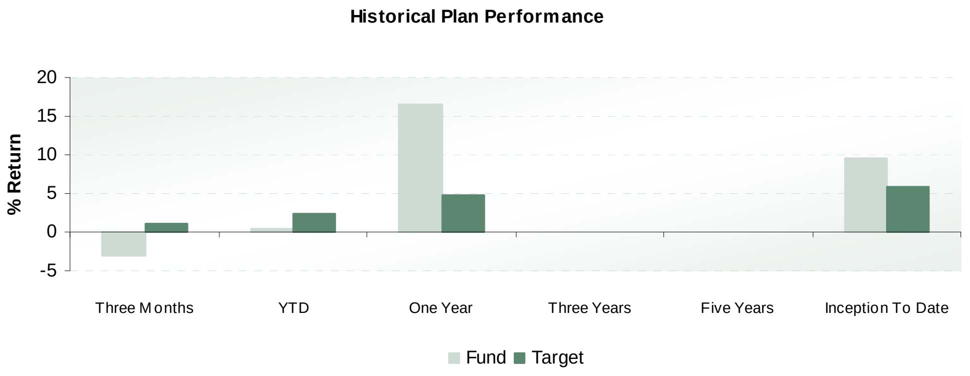


	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
3M Rel	-	-	-	-	-	-	-4.81	4.71	10.51	1.83	3.54	-3.34
3Y Rel	-	-	-	-	-	-	-	-	-	-	-	-

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

Barings

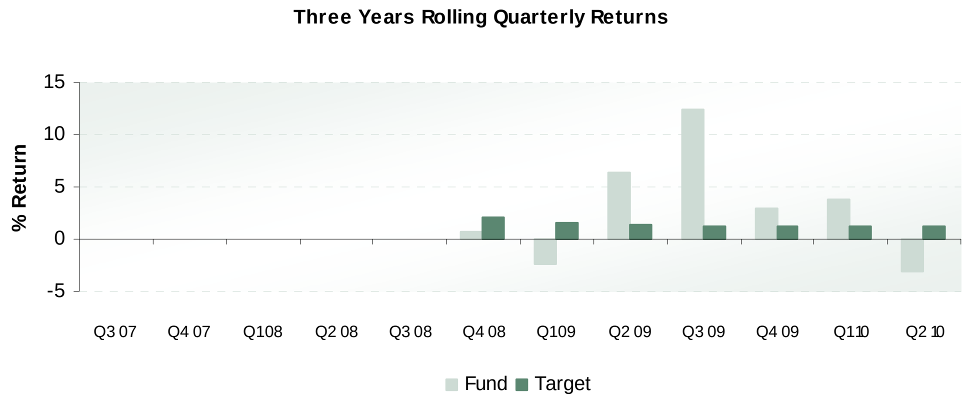
Barings are a large UK based investment manager investing in global asset classes. They were appointed for the Dynamic Asset Allocation mandate in June 2008 following an OJEU tender process. They started managing investments for the fund in August 2008.



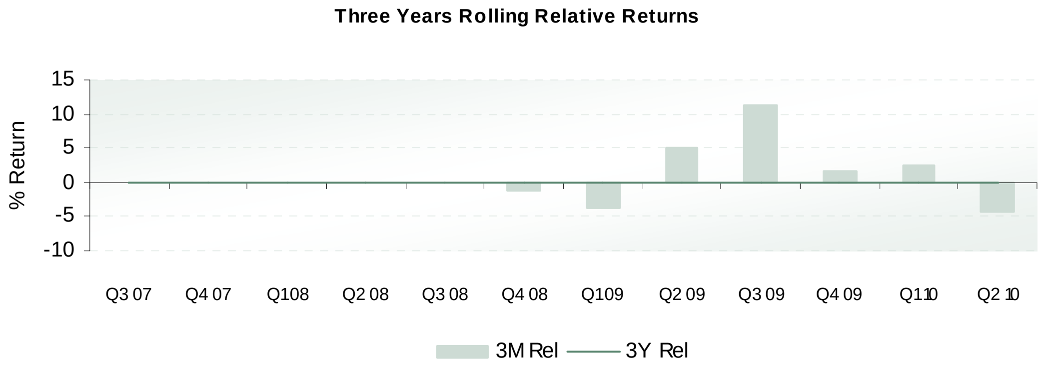
	Three Months	YTD	One Year	Three Years	Five Years	Inception To Date
Fund	-3.12	0.53	16.43	-	-	9.67
Target	1.16	2.31	4.71	-	-	5.90

Quarterly Manager update

Organisation	No significant changes over the quarter.
Product	Barings compensated clients earlier this year by granting additional units for the price adjustment that arose from backdating their fee policy.
Performance	The fund performance was -3.1% over the quarter, 4.3% behind its target. Over 12 months, they are 11.7% ahead of target. The equity holdings provided the largest detractor over the quarter with UK equities falling 11.8% (in line with the market) and the overseas equity falling 13.2%. A fall in the overseas market was compounded by poor stock selection with too much exposure to cyclical industries. Performance was buoyed slightly by the portfolio's holdings in Gold bullion and bonds, a Structured product and the equity hedging instrument employed.
Process	No significant changes over the quarter.



	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
Fund	-	-	-	-	-	0.67	-2.42	6.42	12.50	2.94	3.77	-3.12
Target	-	-	-	-	-	2.01	150	133	1.19	1.14	1.14	1.16



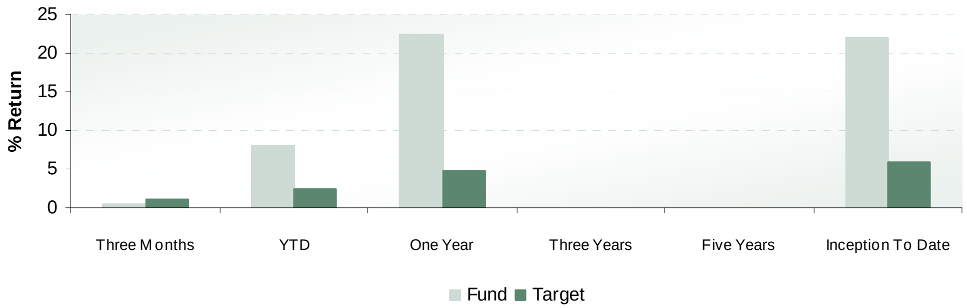
	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
3M Rel	-	-	-	-	-	-132	-3.86	5.02	11.18	178	2.59	-4.23
3Y Rel	-	-	-	-	-	-	-	-	-	-	-	-

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.

Historical Plan Performance

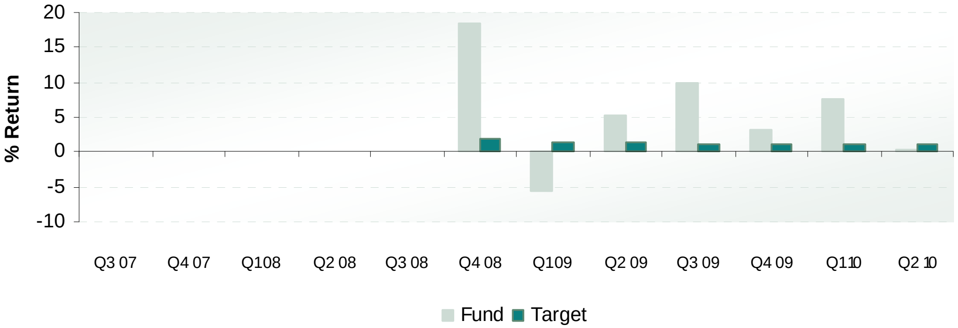


	Three Months	YTD	One Year	Three Years	Five Years	Inception To Date
Fund	0.41	8.09	22.39	-	-	21.95
Target	1.16	2.31	4.71	-	-	5.90

Quarterly Manager update

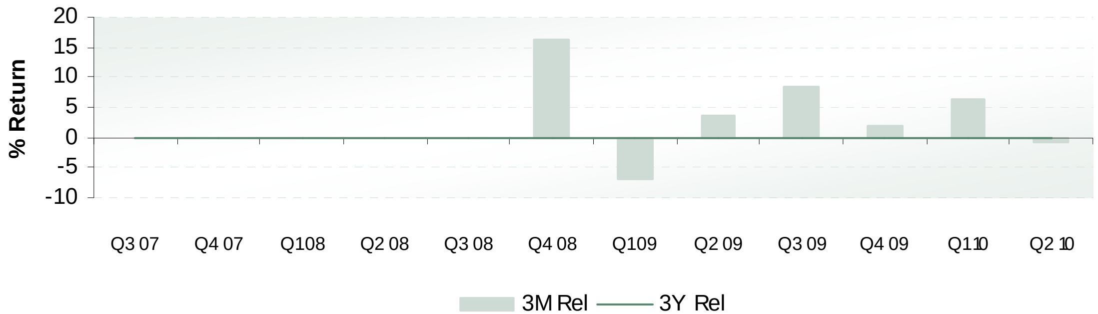
Organisation	No significant changes over the quarter.
Product	No significant changes over the quarter.
Performance	The fund performance was 0.4% over the quarter, 0.8% behind its target. Over 12 months, the fund was 17.7% ahead of target. Weak equity returns particularly in Japan, due to a reversal of the trends which saw strong performance in the Japanese markets in the first quarter and the 49% fall in BP shares over the quarter were the main detractors in performance. Holdings in Gold and the telecoms company Ericsson as well as the portfolio’s US dollar exposure meant a positive return was salvaged over the quarter despite difficult market conditions.
Process	No significant changes over the quarter.

Three Years Rolling Quarterly Returns



	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
Fund	-	-	-	-	-	18.47	-5.49	5.17	9.81	3.12	7.64	0.41
Target	-	-	-	-	-	2.01	1.50	1.33	1.19	1.14	1.14	1.16

Three Years Rolling Relative Returns



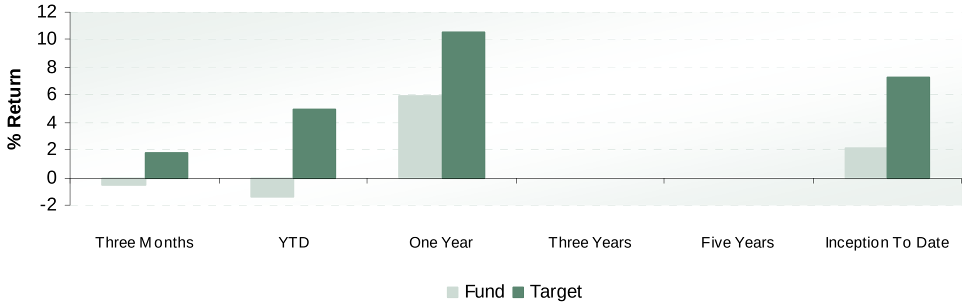
	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
3M Rel	-	-	-	-	-	16.14	-6.90	3.79	8.52	1.96	6.42	-0.74
3Y Rel	-	-	-	-	-	-	-	-	-	-	-	-

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

Matching Fund

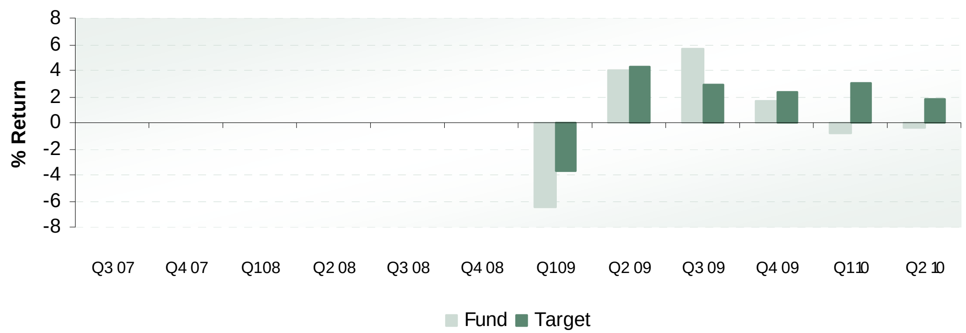
The performance of the Matching Fund over the quarter of -0.5% is below its gilts-based liability benchmark. This can be attributed to relative underperformance of both Legal & General and Goldman Sachs.

Historical Plan Performance



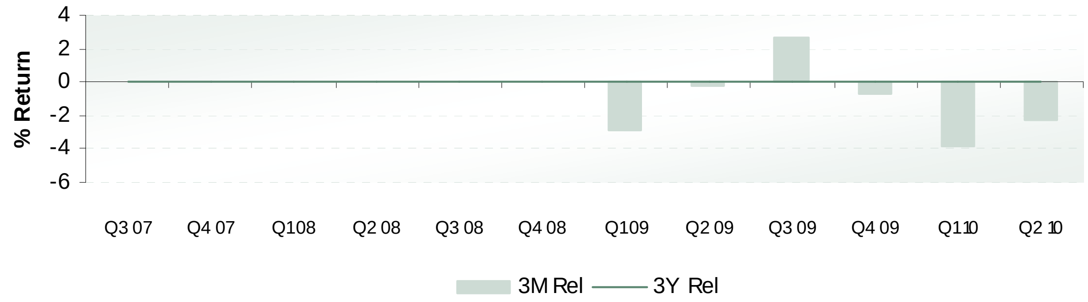
	Three Months	YTD	One Year	Three Years	Five Years	Inception To Date
Fund	-0.48	-135	5.96	-	-	2.08
Target	181	4.89	10.50	-	-	7.20

Three Years Rolling Quarterly Returns



	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
Fund	-	-	-	-	-	-	-6.45	4.04	5.66	167	-0.88	-0.48
Target	-	-	-	-	-	-	-3.68	4.28	2.90	2.38	3.02	181

Three Years Rolling Relative Returns

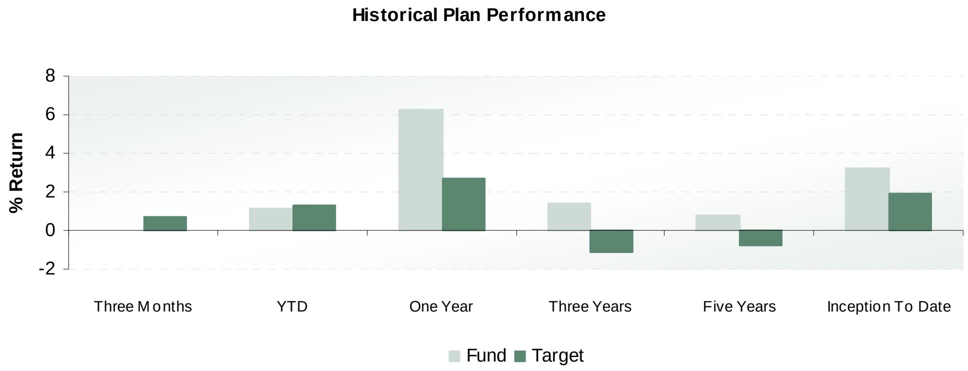


	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
3M Rel	-	-	-	-	-	-	-2.87	-0.23	2.68	-0.69	-3.79	-2.25
3Y Rel	-	-	-	-	-	-	-	-	-	-	-	-

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

Goldman Sachs

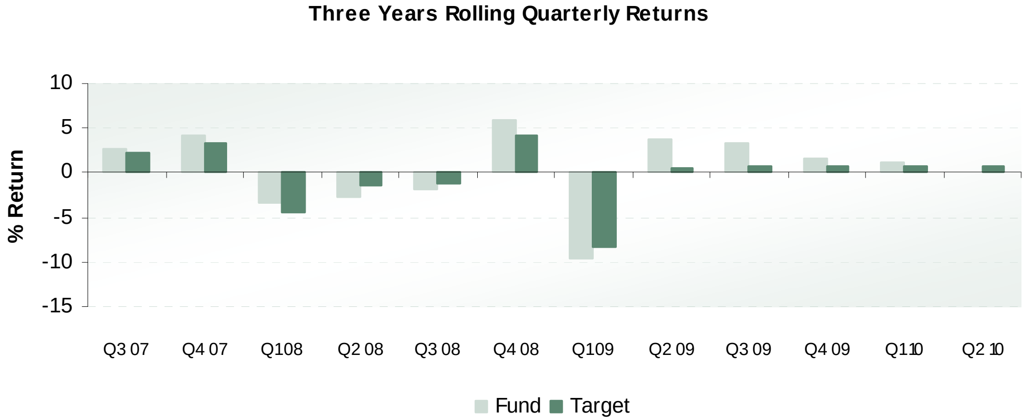
Goldman Sachs are a very large American investment bank who were first appointed in 1999 following a tender process. They have managed both equities and bonds on an active basis and since Feb 09 manage an active bond fund.

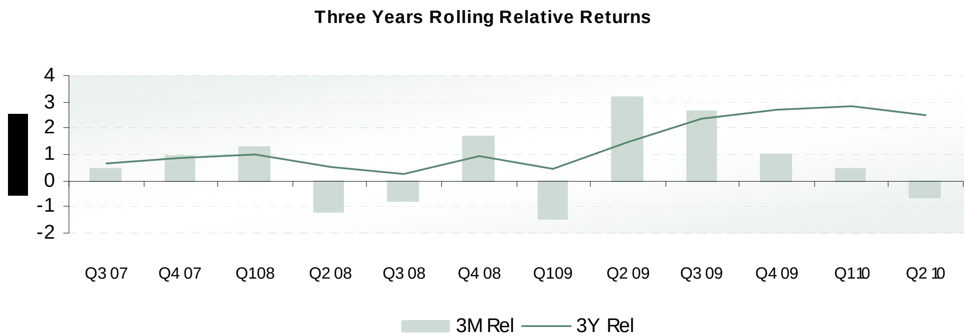


	Three Months	YTD	One Year	Three Years	Five Years	Inception To Date
Fund	0.03	113	6.26	137	0.77	3.26
Target	0.67	133	2.69	-111	-0.77	187

Quarterly Manager update

Organisation	As reported in the previous report, during the quarter the US Securities and Exchange Commission ('SEC') announced that Goldman Sachs is to face a fraud charge. Goldman Sachs is accused of committing civil fraud by selling Abacus (a mortgage-backed security) to investors without telling them hedge fund Paulson & Co was shorting the instrument. It is also accused of failing to reveal it allowed Paulson to select many of the securities held in Abacus.
Product	No significant changes over the quarter.
Performance	The fund performance was 0.0% over the quarter, 0.6% behind its target. Over 12 months, performance was 3.6% ahead of their target. The fund's duration and cross-sector strategies were the main sources of underperformance over the quarter.
Process	No significant changes over the quarter.





	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
Fund	2.60	4.24	-3.27	-2.67	-186	5.86	-9.70	3.78	3.36	166	110	0.03
Target	2.15	3.29	-4.46	-148	-112	4.09	-8.39	0.56	0.70	0.65	0.65	0.67

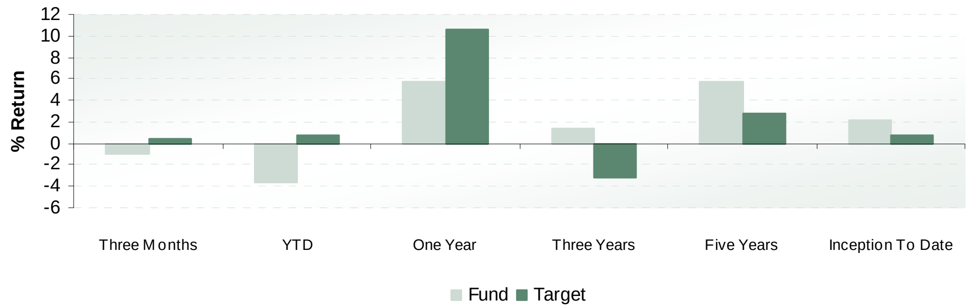
	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
3M Rel	0.44	0.91	124	-121	-0.74	170	-143	3.20	2.64	101	0.44	-0.64
3Y Rel	0.67	0.89	100	0.54	0.27	0.90	0.47	148	2.37	2.68	2.86	2.51

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

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

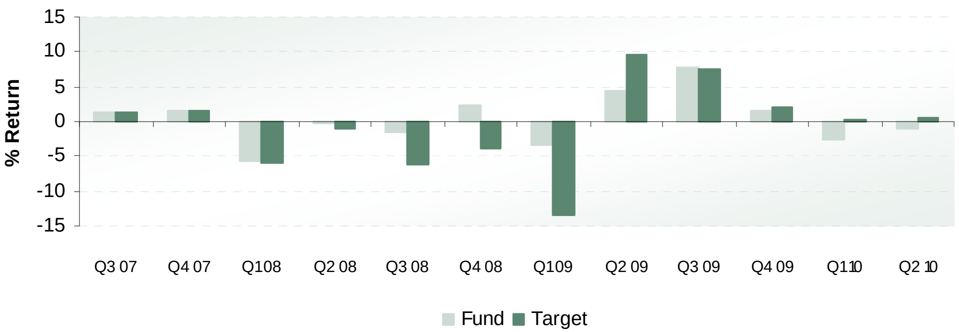
Historical Plan Performance



	Three Months	YTD	One Year	Three Years	Five Years	Inception To Date
Fund	-0.96	-3.62	5.68	130	5.68	2.14
Target	0.39	0.74	10.54	-3.26	2.73	0.69

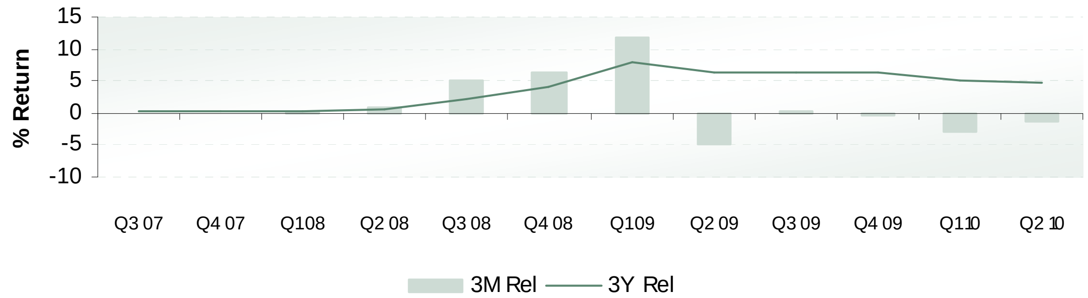
Quarterly Manager update	
Organisation	Chief Executive Peter Chambers has announced that he will retire in September 2010. His replacement has not yet been announced.
Product	No significant changes over the quarter.
Performance	The fund performance was -1.0% over the quarter, 1.4% below its target. Over 12 months, performance is 4.9% behind target. The fund, which is invested in the 2055 Index-Linked Gilt, has again tracked its benchmark over the quarter. Although the return this quarter has been negative, the fund as a whole has continued to achieve its target of tracking its benchmark since inception.
Process	No significant changes over the quarter.

Three Years Rolling Quarterly Returns



	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
Fund	134	166	-5.79	-0.17	-160	2.34	-3.32	4.29	7.85	168	-2.69	-0.96
Target	142	167	-5.98	-0.99	-6.25	-3.90	-13.51	9.52	7.48	2.08	0.36	0.39

Three Years Rolling Relative Returns



	Q3 07	Q4 07	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
3M Rel	-0.08	-0.01	0.19	0.83	4.97	6.49	11.78	-4.77	0.34	-0.40	-3.03	-134
3Y Rel	0.12	0.12	0.12	0.42	2.03	4.16	8.07	6.34	6.46	6.29	5.20	4.71

Notes: All numbers are sourced from the Custodian, Northern Trust, and have not been independently verified. Northern Trust have revised some of the rolling three year fund and target performance numbers from their Q4 2009 report.

Market Commentary – Quarter 2 2010

(28th July 2010)

This is a general market commentary for CAMRADATA Pension Fund clients covering the events of Q2 2010.

After 4 consecutive quarters of growth, Quarter 2 2010 saw a reversal in equity markets, which gave up all the ground gained since the start of the year. Heightened investor concern over the global fiscal debt situation and slowing growth in a number of European countries was the dominant feature impacting both on currencies and capital markets.

The most significant fall was in Europe (ex UK) equities which declined by -14.4% though this was in part due to continuing weakness of the Euro against sterling.

UK equities fell by 11.8% with similar declines seen elsewhere. Even Emerging Markets equities, the top performing area over the previous 12 months, were not immune, declining a more modest -2.3% over the quarter.

The euro-area debt crisis, particularly in Greece but including Portugal, Italy, Ireland and Spain, was considered sufficiently serious to force Member States to agree a coordinated international support package to stem the risk of contagion and underpin market liquidity. Signs of strain within the Euro-zone were apparent at one point when French president Nicolas Sarkozy reportedly threatened to pull out of the euro unless a rescue package was agreed.

Eventually, Member States agreed to a three-year loan facility for Greece. This was followed by a broader official support package. On 2 May, the EU and IMF agreed to provide emergency loans to Greece worth €110 billion and the European Central Bank (ECB) suspended its minimum credit rating criteria for Greek government debt allowable as collateral in its operations. On 10 May this was extended to an emergency funding facility of €720 billion available to all euro-area countries, and the ECB announced that it would intervene in euro-area public and private debt securities markets to ‘ensure depth and liquidity in those market segments which are dysfunctional’.

S&P subsequently downgraded their credit ratings for both Ireland and Portugal and reduced Greece’s rating to junk status.

Against the backdrop of increased investor concerns about fiscal sustainability in some European countries, government bond markets, including the gilt market, experienced sharp price changes. Spreads between yields on certain countries’ government bonds and German bunds widened sharply and sovereign Credit Default Swap (CDS) premiums increased.

Whilst most European Bond markets generally remained out of favour, the UK Gilt market saw strong inflows from overseas buyers.

Coincident with this, sentiment was improved by the new UK coalition government promising a drastic deficit reduction program as their prime objective. Government Bonds, which until recently had been overshadowed by corporate alternatives, provided the best return of +4.5% whilst Corporates themselves produced a return of +2.0%.

Overseas, Emerging Markets debt, the strongest performer within fixed interest over the last year eased back but still delivered a return of +2.8%. Global High Yield Debt however just fell into negative territory returning -0.7%.

Despite generally positive macroeconomic data, short to medium-term market interest rates in the major currencies fell. This reflected perceptions that monetary policies in the major economies would remain accommodative for longer in order to help support the global economic recovery.

The Japanese yen continued to appreciate against Sterling by 7.1% as did the $US which rose by 1.4%. Meantime the Euro as a consequence of the deepening fiscal crisis within the Euro zone, declined by 8.2% relative to Sterling over the period.

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 – Quarter 2 2010

(28th July 2010)

In the UK the main development was the first Budget from the coalition government. The broad thrust was similar in direction to the proposals set out in general terms by Labour pre-election, but went further and faster in its attempt to cut the deficit by means of an unprecedented level of spending cuts extending over several years.

Reactions to the package from financial markets were mixed; sterling strengthened and gilts improved on the prospect of lower debt, but equity investors were more cautious, concerned that the effect of spending cuts and the increase of VAT to 20% could be sufficient to stop and possibly reverse the modest uptrend in economic activity.

Official forecasts, though reduced, still predicted growth post Budget of 1.2% for this year and 2.3% and 2.8% over the following 2 years.

Figures just released show the British economy actually demonstrated unexpected signs of vigour. In the second quarter alone it soared ahead by 1.1% compared to the first 3 months.

This represents the fastest rate of growth for 4 years, though it should be noted that initial figures have become somewhat unreliable and subject to change. If correct, this would be well ahead of the expected quarterly growth rate of 0.6% and represents an annualised growth rate of 4.5%.

This unexpectedly strong figure may have led to the somewhat surprising decision (at the time) of one member of the monetary policy committee, Andrew Sentence voting for an increase in interest rates at the last policy meeting of the Bank of England.

The dominant company story over the period, overtaking Prudentials failure to win shareholder support for its bid for the Asian assets of AIG, was the deepening crisis which BP faced over the explosion of its Macondo well in the Gulf of Mexico and the resultant oil spill.

It came under huge pressure from the US authorities and agreed to create a $20 billion fund to provide compensation to those affected by the oil pollution. The company will still be liable for any penalties levied by the US authorities which will be separate from any claims for compensation. The BP share price fell 50% over the quarter as speculation arose that the scale of compensation and the cost of environmental restitution would exceed estimates. In addition BP has temporarily suspended dividend payments and is looking to sell off assets to help cover the overall costs. At the time of writing the share price has improved modestly from its low at the end of June, following the apparently successful capping of the spill but concerns remain.

Market volatility remains a feature of investment markets. The severe nature of the austerity measures being imposed on countries such as Greece in exchange for bail-out cash has caused a crisis of confidence about future growth levels and the risk is that could well precipitate the debt defaults it was designed to avoid. Further credit rating downgrades are a distinct possibility.

Sources: Reuters; Datastream; Bank of England; Office for National Statistics, Financial Times.

During the height of the credit crisis, one of the most remarkable features was that some seemingly healthy companies disappeared overnight, as a result of the rapidly changing economic, operating and financial conditions. In recognition of this, the Pensions Regulator issued a statement in 2009 specifying the need for prudence through the economic cycle, whilst taking account of economic affordability.

This has been followed in June this year with a consultation document covering proposed guidance on monitoring employer support: covenant, contingent assets and other security. Whilst it will be a while before the final guidance is available, it is clear that the Regulator is keen to ensure that reviewing the employer covenant is a vital component of good governance and is seeking to strengthen the way this is implemented.

The proposed guidance sets out the standard practice in which it expects trustees to assess, monitor and take action on the employer covenant.

What does this mean in practice?

Well, the first port of call is inevitably to understand the strength of the employer covenant. This must be from both a legal perspective, to establish what the employer is committed to, and from a financial perspective in terms of what it can afford. This can only be achieved if there is relevant and up to date information and the trustees should work with the employer to ensure there is clear communication between the parties.

Whilst the current financial health of the employer is a factor in the covenant assessment, this is largely a backward looking metric and hence there is also emphasis on the need for the trustees to focus on more forward looking measures, which should include “the point in the economic cycle of the employer’s industry and of the employer’s position within its economic cycle”, and to critically evaluate “the employer’s ability to recover if at a low point”.

Covenant assessments are demanding and if the trustees do not have the suitable skills necessary, the Regulator makes clear professional advice should be considered. Indeed, the more complex the relationships, the more likely this will be. Group or intra-company arrangements with differing levels of security and commitments are a particularly good example of this.

Effectively assessing the employer covenant and arranging for its ongoing monitoring will, however, help the trustees in numerous areas. These will include the trustees’ approach to scheme funding and the level of caution required, whether the recovery plan should be accelerated in the event of improved cashflow, identification of events that have led to the need to crystallise calls over contingent assets and the level of risk the scheme can accept on investment grounds.

Where there is a strong covenant, the suggestion is that trustees will be able to sustain greater exposure to higher return seeking assets and the higher level of risk that this entails. However, there is no definition of how risk is measured or calculated and most investment consultants would argue that the benefits of a widely diversified portfolio considerably reduce the total level of risk.

For a very weak (or negligible) employer covenant, the expectation is that trustees would need to be able to demonstrate why significant exposure to higher risk investments complied with the best interest of the scheme members. Relying on the Pension Protection Fund in the event of the strategy being unsuccessful would not be acceptable justification.

There are no formal benchmarks to assess covenant strength, but the guidance does intimate grouping into broad categories encompassing “very strong, strong or very weak” for example. However, what it does make clear is that the Regulator’s “initial view on covenant strength will inform” their “initial analysis of the prudence of scheme funding assumptions, and is one of the factors that help identify which funding plans to subject to greater scrutiny”.

Pledging additional security to the scheme may help to strengthen the employer covenant and allow greater flexibility on funding and recovery plans, which in turn may provide an incentive for both the trustees and the employer. Whilst not exhaustive, the options highlighted include agreements to abide by certain performance thresholds and notifying the Trustees when these are breached, providing the same priority alongside other creditors, negative pledges where the consent of the trustees are required prior to implementation of specified events, increased funding on certain developments and the provision of contingent assets.

Where additional security is provided, the trustees will need to establish whether this has any implications for the Scheme on a day to day basis where for example lower initial contributions are agreed but increasing over time as employer profitability improves. In the short term, this approach may require the realisation of assets to accommodate the lower level of contributions. The ongoing management of the security also needs to be considered and steps taken to ensure that it is appropriately maintained.

What does this mean for trustees?

Whilst the trustees should always be mindful of the costs in assessing the employer covenant and there is a stated intention not to incur costs disproportionate to the perceived benefits that provides some latitude especially for smaller schemes, it is clear the Regulator is becoming increasingly keen to raise standards. Given the guidance has not yet been finalised, a degree of caution is still warranted, but there are a number of steps that the trustees may wish to consider immediately including:

- Adopting a pro-active approach.

- Maintaining an emphasis on the prospective covenant with annual monitoring once the financial results are released and a full covenant evaluation prior to each scheme specific funding triennial valuation.

- Including a fixed agenda item at trustee meetings to review any company developments including a review against pre-specified trigger points to ensure any deterioration in the covenant can be addressed at the outset. This may ultimately result in calling in security or realigning the investment portfolio for example.

- Considering an increase to the strength of the employer covenant, if appropriate.

- Ensuring there is a positive relationship with the employer to help the flow of information and signing confidentiality agreements to facilitate.

- Carrying out a proper selection process if there is a requirement for external advice. As part of this, the perceived benefits should outweigh the expected costs.

If you have any queries, please contact your usual CAMRADATA representative.

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