The Royal Borough of Kensington and Chelsea
Investment Committee

Pension Fund
Report and Accounts
2011-12

September 2012

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The following sections have been agreed to the Committee before and will be presented to the November meeting to see if amendments are required before publication as part of the web version of the final document

Chairman's Introduction

The Council carries the very considerable responsibility of providing pensions for its employees in retirement. Over 2011-12, it invested nearly £27.5 million of contributions, funded in part by current employees but mainly by the Council as a part of the cost of providing services to residents.

The Investment Committee determines a strategy for investing these funds and appoints and oversees a set of professional fund managers. If the committee's strategy and the fund managers' decisions are sound, these costs should be contained. If either fails, the local taxpayer runs the risk of an increase in Council Tax to help the Council meet its obligations.

In 2011, greatly assisted by the late Councillor Andrew Dalton, the Investment Committee completed a restructuring of the fund and appointed several new fund managers. We have in particular appointed two managers who aim for an 'absolute return' that is to increase the real value of the funds they invest rather than to match or beat a particular stock market index. This is in part our response to the particularly turbulent and unpredictable market conditions that have prevailed since 2008.

It is much too soon to say whether this strategy will pay off. But it is slightly encouraging that the fund achieved an overall return over 2011-12 of 3.6 per cent. This exceeded the average movement of the price and market indices used to measure performance by 1.9 per cent. But as we expect there to be such over-performance, by about 2.3 per cent, the fund's growth fell 0.4 per cent short of the target.

We shall naturally aim to do better in 2012-13!

Cllr Mary Weale

1 Management of the Fund

1.1. The Council has a statutory responsibility for the management of the Local Government Pension Scheme (LGPS) within its area. It is also responsible for making strategic decisions governing the way the scheme is invested. In this respect, the Council delegates responsibility for making investment decisions and monitoring arrangements to the Investment Committee. The Investment Committee's responsibilities include reviewing and monitoring the Fund's investments, selecting and deselecting investment managers and other relevant third parties and establishing investment objectives and policies.

1.2. During 2011-12 the Investment Committee comprised six elected Members from the Royal Borough of Kensington and Chelsea, all of whom have voting rights. Five were Conservatives drawn from the majority party and there was one Labour member from the minority party. There were also four co-opted, non-voting members with investment backgrounds to advise the Committee. Professional advisers are also present throughout each meeting.

1.3. Meetings of the Committee are held four times a year. They are used to review performance in the previous quarter and deal with current and forthcoming issues relating to the investments and governance.

1.4. Northern Trust is the Fund's global custodian and also provides measurement services for the performance of assets. Northern Trust acts as custodian for all of the Fund's assets apart from the working cash balances, which are managed internally by officers of the Council.

1.5. Barnett Waddingham LLP acted as the Fund's actuaries and completed a valuation under International Accounting Standard 26 (IAS26) methodology for the Royal Borough as administering body. Each quarter, Barnett Waddingham report to the Investment Committee with a summary calculation of the Fund's assets, liabilities and overall funding position.

1.6. Hymans Robertson provide investment advice to the Fund at all normal meetings of the Investment Committee.

1.7. The Fund is an exempt approved fund under the Finance Act 1970, and is therefore exempt from Capital Gains Tax on its investments. At present all Value Added Tax is recoverable, but the Fund is not able to reclaim the tax on UK dividends.

Asset Allocation

1.8. The Investment Committee made a number of significant decisions to restructure the portfolio during 2010-11. Key amongst these were:

- Agreement that global benchmarks would apply to all equity-type investments.
- 60 per cent of the Fund would be allocated to global equities, split equally between two active and one passive manager.
- In order to increase the Fund's ability to generate equity-type returns, but also to allow for greater flexibility in the allocation of funds, 30 per cent of the Fund would be allocated to absolute return managers.
- The allocations of five per cent each to private equity and property would remain unchanged.

1.9. As a result of the selection process, Baillie Gifford were re-appointed with a new, active global mandate which was funded in November 2010. A further new, active global mandate with a different strategy was funded to the same level (£98 million) with Longview Partners and the existing investment with Legal and General was increased to £97 million.

1.10. Two absolute return managers, Barings and Pyrford, were selected early in 2011, but they were not funded until April 2011. Again, managers with contrasting styles were chosen with the intention that they should complement each other: £77 million was allocated to each.

2. Financing the Fund

2.1. The Fund is financed by employer and employee contributions and the income derived from investments. Every three years the Fund Actuary carries out a valuation, which determines the level of employer contributions. The Council and other employers are responsible for meeting the costs of non-statutory enhancements to pensions arising from early retirements or redundancy (if any) and for restoring any funding deficits.

2.2. Since 2008-09, most individual employers in the Fund have had their own contribution rates, determined by their membership profiles. They are therefore responsible for the "experience" of their members and each has its own nominal asset allocation within the overall Fund, although the investments continue to be managed as a whole by the administering authority.

2.3. The organisations participating in the Fund at 31 March 2012 are listed below, along with the contribution rates set at the 2007 valuation.

Organisation	**Contribution Rate in 2011-12 (per cent)**
Royal Borough of Kensington and Chelsea	21.5
Scheduled Bodies	
Kensington and Chelsea College	16.0
St Charles Sixth Form College	21.5
Chelsea Academy	21.5
Admitted Bodies	
Tenant Management Organisation	22.5
Specialist Schools and Academies Trust*	13.5
Westway Development Trust	20.0
Medequip Assistive Technology	24.3

* In May 2012 The Specialist Schools and Academies Trust went into administration. Officers are working with the administrators to recover as much of the organisation's liability to the Pension Fund as possible.

2.4. During 2010, Barnett Waddingham completed their first triennial valuation for the Royal Borough and reported that the scheme was 89 per cent funded as at 31 March 2010, with a deficit of £58 million between its assets and liabilities. Given this result, contribution rates were held stable for all employers in the Fund and the target to eliminate the deficit by 2020 was maintained.

2.5. The contribution rates arising from the 2010 valuation were introduced on 1 April 2011 and will remain in place for three years. The full 2010 Actuarial Valuation Report is available on the Council's website, http://www.rbkc.gov.uk .

2.6. Barnett Waddingham provide the Investment Committee with quarterly updates of the funding position on the triennial valuation and, as at 31 March 2012 were able to report that the scheme was 90 per cent funded.

3. Investment Policy

3.1. The Fund's detailed investment objectives and policies are set out in a Statement of Investment Principles and a Funding Strategy Statement, which are published for Council Tax payers, employees and other interested parties via the Council's Web Site http://www.rbkc.gov.uk

3.2. Day to day investment management of the Fund's assets is delegated to professional investment managers in accordance with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009.

3.3. Specific investment benchmarks, aligned to the Fund's investment objectives, are set for each of the managers along with an out-performance target. These are shown in the table below:

Manager and Sector	**Benchmark Weight %**	**Benchmark**	**Outperformance Target over Benchmark**
Baillie Gifford Global Equities	20	MSCI All Countries World Index	+ 2%
Longview Global Equities	20		+ 2%
Legal and General Global Equities	20	MSCI All Countries World Index	0% (Passive fund)
Barings Global Absolute Return	15	3 month LIBOR	+ 4%
Pyrford Global Absolute Return	15	Retail Price Index	+ 5%
Adams Street Global Private Equity	5	MSCI World Developed Countries Index	+ 2%
CBRE UK Property	5	HSBC/AREF All Balanced Funds	+ 0.5%
Whole Fund	**100**	**Composite Benchmark**	**+ 2.3%**

3.4. The smaller holdings in a property fund of funds and a private equity fund of funds, are managed by CBRE Global Investors and Adams Street Partners respectively. The Committee takes a particularly long term view of these asset classes.

3.5. It is anticipated that the investment into private equity will continue to be drawn down from the Fund's cash reserves as investment opportunities arise over the coming years at a rate of around £4 million per year. Income from this investment is expected to offset this by 2013

3.6. Day to day cash balances were managed by the Council during 2011-12. In order to meet the requirements of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009, a separate current account is operated for the Fund with the Council's bankers, RBS/NatWest. This is linked to an interest bearing account for cash-management purposes.

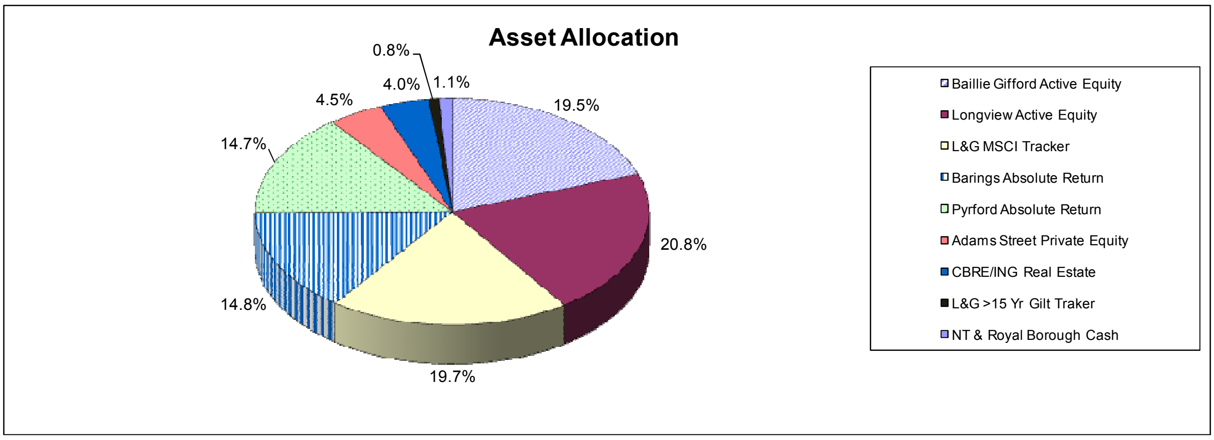
3.7. In late 2011, £4 million was invested in Legal and General's index-linked gilt tracking fund in order to maintain the value of the Fund's more liquid holdings, while keeping individual deposits below the £10 million deposit limit which the Committee considers prudent to maintain with any single banking group.

4. **Investment Performance**

4.1. Despite continuing turbulence in the markets, asset values increased during 2011-12. At the close of the year, the Fund's assets were valued at £541 million, an increase of £21.5 million on their level at 1 April 2011. They were allocated as shown in the chart below:-

FAIR VALUE OF RBKC PENSION FUND ON 31 MARCH 2012

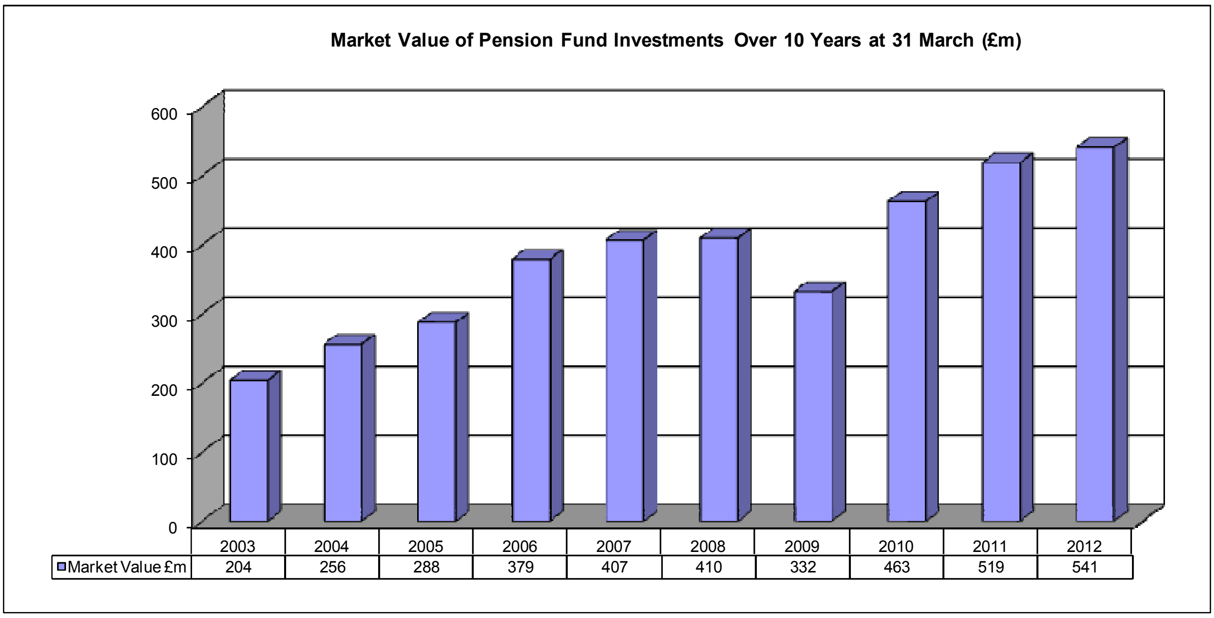
Summary	Equities 60.1%			Absolute Return 29.5%		Alternatives 8.5%		Cash and IL Gilts 1.9%		
	Baillie Gifford Active Equity	Longview Active Equity	L&G MSCI Tracker	Barings Absolute Return	Pyrford Absolute Return	Adams Street Private Equity	CBRE/ING Real Estate	L&G >15 Yr Gilt Traker	NT & Royal Borough Cash	Total
	19.5%	20.8%	19.7%	14.8%	14.7%	4.5%	4.0%	0.8%	1.1%	100%
£'000	105,700	112,700	106,400	80,200	79,500	24,400	21,700	4,300	5,900	540,800



Performance over the long term and in 2011-12

4.2. For the year to 31 March, with the positive return on investments of 3.6 per cent, the Fund saw growth of 1.9 per cent more than the composite benchmark of the managers' indices, but fell 0.4 per cent short of the overall target. This was better than in 2010-11 when the targeted performance objective was missed by 1.3 per cent.

4.3. Over the last ten years the market value of the fund has changed as indicated in the chart below:



4.4. Due to the extensive restructuring of the Fund in the last two years, the performance of most individual managers is only available for one year – 2011-12. This is not sufficient to give a true picture of how the new structure and strategies are working: this will require three years. But it does give an indication of how each manager has performed in the initial period.

4.5. **Baillie Gifford** has a long and successful history of managing the Fund's assets and was reappointed in November 2010 on a new actively managed Global Alpha mandate. This is a pooled fund which can be invested in a wide variety of quoted stocks in developed and emerging markets. The strategy is to invest on the basis of the quality of companies' prospects over the long term. Although the portfolio outperformed the MSCI All World Index by 1.5 per cent, difficulties in some emerging market economies meant that performance fell short of the target of the index plus 2 per cent by 0.5 per cent.

4.6. **Longview Partners** were a new appointment, funded from November 2010. They actively manage a segregated portfolio of quoted developed world stocks. Although the quality of companies' prospects is also a key driver in their stock selection process, the emphasis on a small number of stocks in relatively few markets (most holdings are in the USA) means there is little overlap with Baillie Gifford's portfolio. This approach was highly successful in 2011-12, delivering a 6 per cent return over the MSCI Developed World Index, 4 per cent above their target to exceed the index plus 2 per cent.

4.7. **Legal and General** provides the Fund's passive global equity exposure in a pooled fund composed of quoted equities. They met their target to track the MSCI All World Index. The apparent "underperformance" of 0.1 per cent is accounted for by their fees.

4.8. **Barings** were appointed early in 2011 and funded with £77 million in April 2011. This is a global pooled absolute return fund, largely invested in bonds and equities, but able to switch between asset classes in order to protect capital or achieve growth according to market conditions. Barings also include other assets in this fund, such as commodities and leasing contracts, if there appear to be opportunities in these areas. This fund is measured against 3 month LIBOR plus 4 per cent. It achieved 4.7 per cent over the year, 0.5 per cent short of its target.

4.9. **Pyrford** were also appointed early in 2011 and funded with £77 million in April. This is also a global pooled absolute return fund and is almost entirely invested in bonds and equities. It is intended to complement the Barings allocation by being more conservatively managed. This fund is measured against the Retail Prices Index plus 5 per cent. It achieved a return of 3.8 per cent over the year, 4.5 per cent short of its target.

4.10. The **Osiris UK property** fund-of-funds was transferred from ING Global Investors, along with the other ING property holdings through a merger of the two operations during 2011-12. The portfolio marginally exceeded its target to beat the IPD UK All Balanced Funds Index by 0.5 per cent, achieving a return of 5.8 per cent for the year. Over three years, the portfolio returned 10.9 per cent, exceeding the target return by 1.8 per cent.

4.11. **Adams Street Partners** provide a global private equity fund of funds which invests in a wide range of funds as well as directly in companies, including new ventures around the world, although the firm is based in Chicago and holds most of its assets in the United States. In 2011 the Investment Committee decided that a further US$ 30 million would be committed to maintain this investment at approximately 5 per cent of the overall Fund.

4.12. Since the first investment in 2007, 40 per cent (around £25 million) of the total of $100 million (around £63 million) committed has been drawn and $7.9 million (approximately £4.9 million) has been received as distributions. The portfolio returned 8.2 per cent in 2011-12, exceeding its target of 3.5 per cent by 4.7 per cent. These returns are only just beginning to become meaningful, due to the long term nature of private equity investing.

4.13. Quarterly updates on the Fund's performance are posted on the Council's website ahead of each of the Investment Committee meetings.

5. Administration Arrangements of the Fund

5.1. The Superannuation Act 1972 makes provision for local authorities to operate pension funds for their employees and employees of other employers who have a either a statutory right or an admission agreement to participate in the funds.

5.2. The Royal Borough of Kensington and Chelsea Pension Fund (The Fund) is set up under the Local Government Pension Scheme Regulations 1997 (as amended). It provides for retirement pensions, grants on age or ill-health retirement, short service grants, death grants, injury allowances and widows' pensions.

5.3. The Fund is operated and administered by the Royal Borough of Kensington and Chelsea which, up to September 2007, managed pension administration functions internally.

5.4. The Fund is financed by employer and employee contributions and from income derived from investments. Every three years the Fund Actuary carries out a valuation, which determines the level of employer contributions. The Council and other employers are responsible for meeting the costs of non-statutory enhancements to pensions arising from early retirements or redundancy (if any).

5.5. The Fund's investments continue to be accounted for internally, but administration relating to the membership of the Fund is provided in the main by Capita Hartshead. The contractor provides the main point of contact for members and pensioners, the maintenance of membership records, transfers in and out of the Fund, and the calculation of pension benefits and lump sums.

5.6. The contractor's effectiveness is overseen by the administering authority's Pensions Client Team which provides a liaison function and administers contributions from admitted and scheduled bodies and payments to members.

5.7. The Fund provides benefits for employees of the Council, Admitted and Scheduled bodies. The larger Admitted and Scheduled bodies take individual responsibility for the experience of their members and are allocated a nominal proportion of the assets and separate employer contribution rates.

5.8. Teachers, lecturers and youth workers are subject to different pension fund arrangements. These are administered by the Department for Education, to whom the Council makes payments for this purpose.

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6. Actuarial Valuation of the Fund

6.1. The accounts summarise the transactions and net assets of the Fund, but do not take into account future liabilities to pay pensions and other benefits. The ability of the Fund's contributions and investments to meet its overall commitments is reviewed in detail by its appointed independent actuaries (Barnett Waddingham) every three years.

6.2. The latest actuarial valuation report was as at 31 March 2010. It assessed the market value of the scheme's assets at £451 million and its liabilities at £509 million. This corresponds to a funding level of 89 per cent, a 4 per cent improvement on the level at the 2007 valuation.

6.3. The actuarial valuation used the projected unit method and is based on economic and statistical assumptions made by the actuaries. The main ones are:-

- The rate of accumulation of income and capital on new investments over the long-term and the increase from time to time of income from existing investments;
- Future rises in pensionable pay due to inflation etc., and pension increases;
- Withdrawals from membership due to mortality, ill health and ordinary retirement; and
- Progression of pensionable pay due to promotion.

6.4. Each quarter the actuary provides a summary assessment of the Fund's assets, liabilities and funding level. This information is presented to the Investment Committee to help members assess whether the Fund's investment strategy is working to achieve the long-term objective of having a fully funded scheme by 2020.