

The Royal Borough of Kensington and Chelsea

**Pension Fund
Report and Accounts
2005/06**

July 2006

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1 Introduction

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. 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.

The Fund provides benefits for its employees and the employees of other admitted or scheduled bodies. Teachers, lecturers and youth workers, are subject to different pension fund arrangements. These are administered by the Department for Education and Skills, to whom the Council makes payments for this purpose.

1.1 Tax Status

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.

1.2 Operation and Administration

The Fund is operated and administered by the Royal Borough of Kensington and Chelsea who implement the benefits operations internally. Day to day investment management of the Fund's assets is delegated to expert investment managers in accordance with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended). The two equity managers operate with different investment styles: Baillie Gifford (growth style bias) and Alliance Bernstein (value style bias). Prudential M&G manage a specialist bond portfolio. Specific investment benchmarks, aligned to the Fund's investment objectives, are set for each manager along with an out-performance target of +0.75% for the bond manager and +2% for each of the equity managers before deduction of fees.

Specialist investment consultancy advice is received from PSolve Asset Solutions. An independent global custodian, HSBC, carries out custody of the Fund's assets and HSBC's Global Fund Services arm maintains the prime accounting records.

1.3 Scheme Governance

The Council is statutorily responsible for the management of the scheme and for making strategic decisions that govern 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.

The Fund's investment objectives and policies are published in a Statement of Investment Principles, which is disseminated to Council Tax payers, employees and other interested parties via the Council's Web Site (www.rbkc.gov.uk).

During 2005/6, the Fund was required to consult on and prepare a Funding Strategy Statement and a Communications Policy Statement in accordance with the Local Government Pension Scheme (Amendment) regulations 2004. These were approved by the Chairman of the Investment Committee in March 2006 and were implemented with effect from 31 March, as required.

1.4 Funding

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).

1.5 Employers in the Fund

The employers in the fund as at 31st March 2006 were: -

Scheduled Bodies	Admitted Bodies
Royal Borough of Kensington and Chelsea	Tenant Management Organisation (TMO)
Kensington and Chelsea College	Specialist Schools and Academies Trust
St Charles Roman Catholic Sixth Form College	Kensington Housing Trust
	Westway Development Trust
	West London Family Service Units
	Maxilla Nursery
	Portobello Business Centre
	Housing Action Centre
	Chelsea Community Association
	Medequip

1.6 Actuarial Valuation

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 a firm of independent actuaries every three years. Following a review of actuarial service providers, Hymans Robertson were appointed in 2000 and carried out the 2001 and 2004 valuations. The contribution rates for 2005/06 were based on the 2004 valuation.

The market value of the scheme's assets at 31 March 2004 was £256 million.

The Valuation was carried out in accordance with the Projected Unit Method and was based on the following economic assumptions:

	Nominal	Real
Investment Return (Longer term)	% p.a.	% p.a.
Equities	7.2	4.3
Bonds	4.9	2.0
Pay Increases (excl increments)	4.4	1.50
Price Inflation/Pension Increases	2.9	-

The Actuary's second full valuation of the Fund was undertaken as at 31 March 2004 and valued the scheme's assets at £256 million. This gave a funding level (ratio of assets to past service liabilities) of 78%. As a result of the lower level of funding (it was 101% in 2001) and the increased assessment of the Fund's liabilities, the employers' contribution rates have been assessed to rise from just under 12% of payroll at the 2001 valuation to 20.5% of payroll from 2005/06 to 2007/08 to repay the deficit over a period of 12.5 years.

The Actuary has produced a crude estimate of the funding level at the end of 2005/06, indicating an improvement to around 92%, due to the better than expected performance of the Fund's investments during the year. However, by the end of May 2006, it was estimated that the funding level had dropped back to 89%.

More details of the latest valuation and its impact on contribution rates for the years from 2005/06 onwards are given in paragraph 10 of the Pension Fund Accounts.

2 Report of the Investment Committee

The Fund moved to its new structure under a new benchmark in February 2003 so 2005/06 was the third complete year of operation under the revised mandates. Following a 2002 review of the liabilities of the fund, and of the asset structure, the Investment Committee decided to change the asset allocation in order to match the liabilities more closely. A higher proportion of the Fund was therefore moved into bonds, slightly lowering exposure to equity markets. The broad split is 30% bonds and 70% equities and the fund is “rebalanced” from time to time in order to maintain these proportions. Within these allocations, diversification is achieved by allocating amounts to investment grade corporate bonds (above a credit rating of BBB) and by investing in overseas equity markets, including emerging markets.

Following an Asset Liability Study presented by the Fund’s Consultant in May 2006, and presentations from a variety of asset managers, the Investment Committee decided to diversify the Fund’s investments further by allocating up to five per cent of the total to an investment in property and a similar amount to private equity. Quotes were sought for a consultant to advise the Investment Committee during the selection process. Hymans Robertson were appointed and have reported back with information on a variety of potentially suitable fund of funds investments, from which the Investment Committee has selected shortlists for interview. The process will be concluded during the 2006/07 financial year with the appointment of two new fund of funds managers.

The Fund was not rebalanced during 2005/06, with a view to making the necessary adjustment to rebalance when the new property and private equity managers have been appointed (expected in mid - 2006). As at 31 March 2006, the non-cash part of the Fund was invested 23.3% in bonds and cash and 76.7% in equities.

Removal of the tax credit on UK dividends in 1998 continues to affect the Fund’s income adversely. Had the tax credit still been in place, it would have been worth approximately £800,000 to the fund in 2004/05 and £1,100,000 in 2005/06.

Councillor John Cox

Chairman of the Investment Committee

July 2006

3 Investment Performance

3.1 Fund Manager Performance 2005/06

The performance of the individual managers and the Fund as a whole, compared to the customised benchmark set, is as follows:

Manager	Benchmark	Performance	Difference	Notes
Alliance Bernstein	31.6 <i>(13.2)</i>	32.2 <i>(17.6)</i>	+0.6 <i>(+4.4)</i>	1
Baillie Gifford	31.6 <i>(13.2)</i>	37.4 <i>(12.4)</i>	+5.8 <i>(-0.8)</i>	1
Prudential M&G	10.0 <i>(6.0)</i>	9.7 <i>(6.6)</i>	-0.3 <i>(+0.6)</i>	2
Total Fund	24.9 <i>(11.0)</i>	28.0 <i>(12.7)</i>	+3.1 <i>(+1.7)</i>	3

Notes (2004/5 performance shown italicised in parenthesis)

- 1 Target out-performance = +2.0% on a rolling 3 year basis
- 2 Target out-performance = +0.75% on a rolling 3 year basis
- 3 Weighted target out-performance = +1.625% on a rolling 3 year basis

3.2 Fund Manager Performance over three years

Now that all of the managers have been investing on the Fund's behalf for at least three years, it is possible to compare their performance over the full period for the first time:

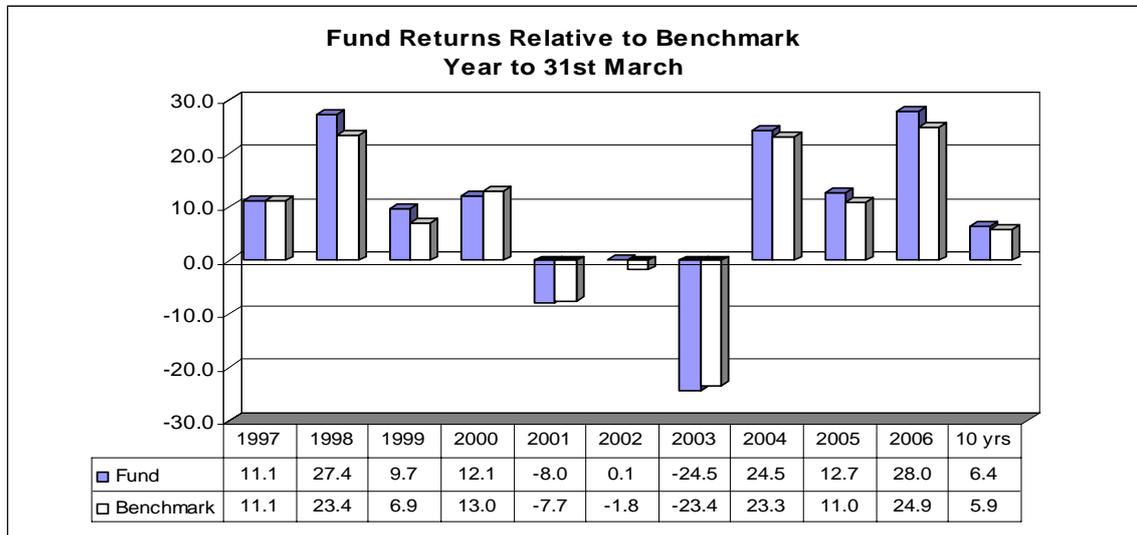
Manager	Benchmark	Performance	Difference	Notes
Alliance Bernstein	25.2 <i>(N/A)</i>	27.8 <i>(N/A)</i>	+2.6 <i>(N/A)</i>	1
Baillie Gifford	25.2 <i>(4.5)</i>	25.9 <i>(4.3)</i>	+0.7 <i>(-0.2)</i>	1
Prudential M&G	7.0 <i>(N/A)</i>	7.3 <i>(N/A)</i>	0.3 <i>(N/A)</i>	2
Total Fund	19.6 <i>(1.6)</i>	21.4 <i>(1.8)</i>	+1.8 <i>(+0.2)</i>	3

Notes (2004/5 performance shown italicised in parenthesis)

- 1 Target out-performance = +2.0% on a rolling 3 year basis
- 2 Target out-performance = +0.75% on a rolling 3 year basis
- 3 Weighted target out-performance = +1.625% on a rolling 3 year basis

3.3 Long Term Fund Performance – 10 years

The performance of the Fund over the past 10 years is shown below (note that benchmarks and managers changed with effect from 2004).



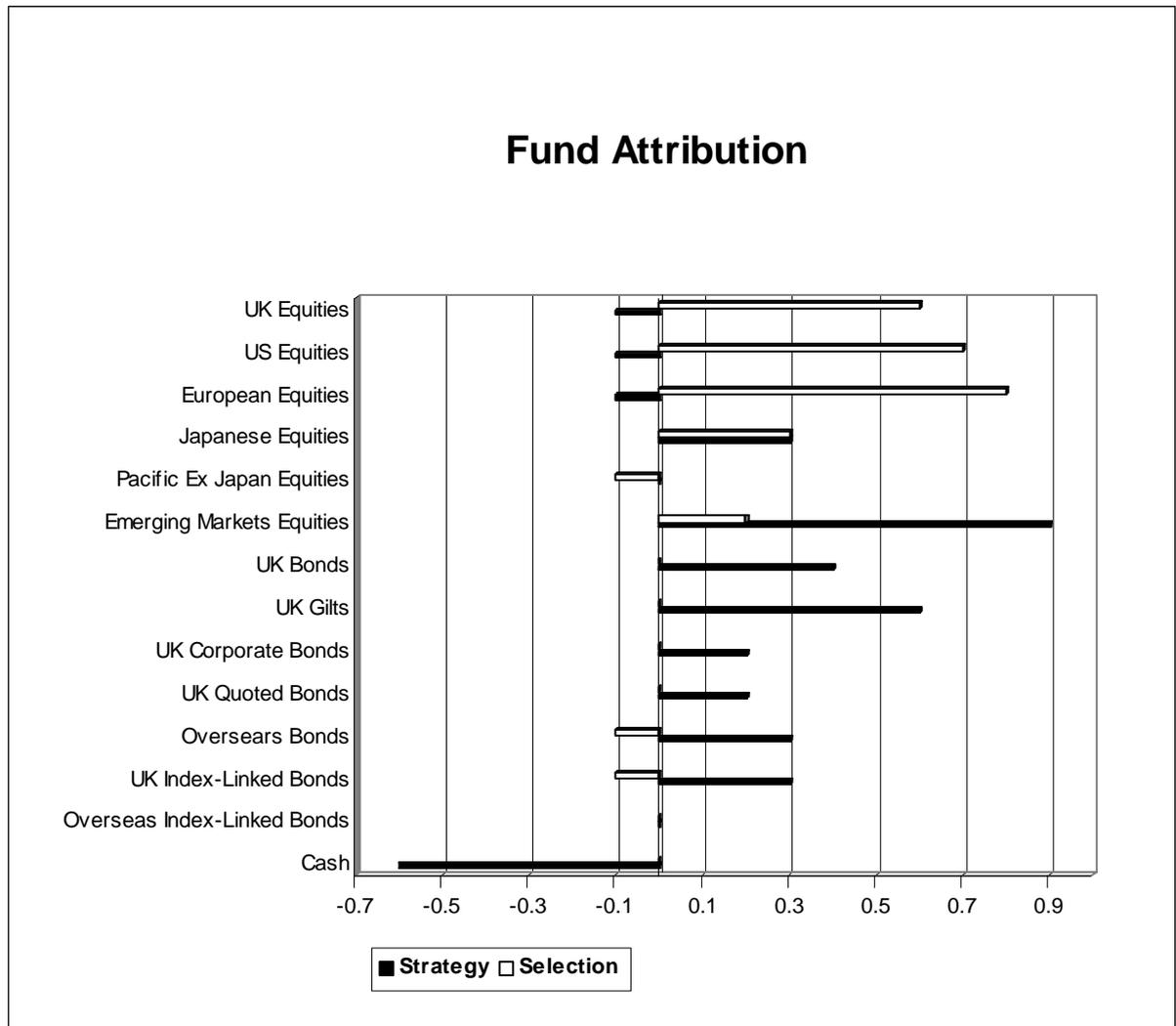
3.4 Market Value of the Fund – 10 years

The market value of the Fund over the past 10 years is shown below (including new money added to the fund).



3.5 Fund Attribution to 31st March 2006

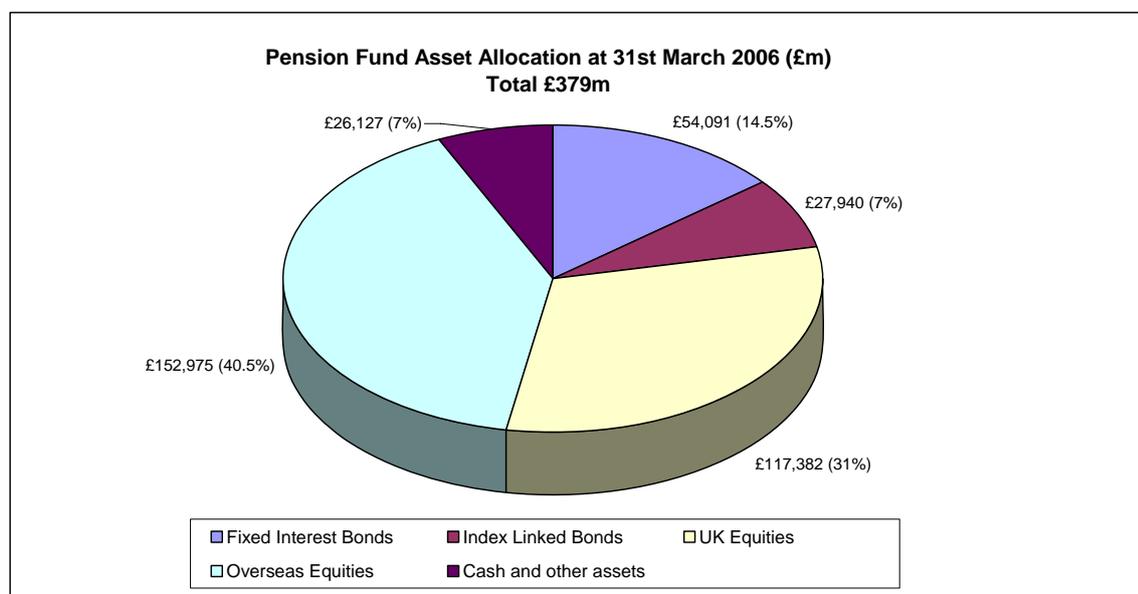
Over the year, the return for the Fund was 28.0% and the benchmark return was 24.9%. Sector level attribution is shown in the following table:



3.6 Asset Allocation

The asset allocation at the 31st March 2006 was as follows:

The total market value of the Fund held in equities was 71.5% at 31 March 2006, with bonds making up 21.5% and cash 7%.



3.7 Turnover During The Year

Turnover during 2005/06 was marginally lower than in 2004/05 as fewer sales were made than in the previous year, though increased dividend income increased re-investment opportunities.

Investments At Cost	2005/06	2004/05
	<i>£'000</i>	<i>£'000</i>
Purchases	92,550	88,932
Sales – Actual	72,840	80,887
Total Turnover	165,390	169,819

4 Pension Fund Accounts

4.1 Statement of Main Principles Adopted in Compiling the Accounts

1. The Council's Pension Fund is based on a funded defined benefit scheme operated under the provisions of the Local Government Superannuation Acts and provides for pensions, grants on age or ill health retirement, short service grants, death grants, injury allowances and widows' pensions.
2. The Fund is financed by contributions from employers and employees of the Royal Borough and admitted / scheduled bodies and by earnings from investment of fund monies. A full list of the admitted and scheduled bodies is shown in Note 15.
3. The total numbers of active members and beneficiaries at 31 March were as follows:

	2006	2005
Active Members	3,206	3,146
Pensioners and Dependents	2,036	2,004
Former Employees - Deferred Benefits	2,515	2,387
Total	7,757	7,537

4. The Pension Fund accounts have been prepared in accordance with the accounting recommendations of the Financial Reports of Pension Schemes - a Statement of Recommended Practice, Chapter 2 Recommended Accounting Practice. Disclosures are as required by the Code of Practice on Local Authority Accounting in the United Kingdom: a Statement of Recommended Practice (SORP).
5. In accordance with the requirements of the SORP, investments are stated at market value with any surplus or deficit on revaluation being credited direct to the fund balance. The market value of securities is determined by closing middle prices on 31 March. Fixed interest securities are valued on a 'clean' basis (i.e. excluding accrued interest). Purchase and sales transactions in foreign currencies are converted to sterling using a pooled average exchange rate.
6. External Managers administer the investments of the Fund and the cost of this is shown in the Fund Account. Internal administration expenses are charged directly to the Pension Fund on the basis of direct costs plus apportioned overheads.

7. Pensions to staff are provided from the Pension Fund whose summarised accounts are shown below. All pension payments, except added years relating to early retirements prior to 1998/99, are paid from the Fund. Employers' contributions, at rates advised by the Fund's actuaries (Hymans Robertson) are credited to the Fund as received. Since 1998/99 additional employer's contributions have been made as a capital sum to the Pension Fund, following the early retirement of employees. The contributions are based on a formula, provided by the actuary, to cover the cost of early payment of pension benefits and discretionary enhancements.
8. Investments of the Fund are exempt from Capital Gains Tax but tax on UK Dividends is irrecoverable. All Value Added Tax paid is recoverable. There is a liability for Income Tax at 20% for pensions compounded into a lump sum. This liability is a minimal sum.
9. The accounts summarise the transactions and net assets of the Fund. They do not take account of liabilities to pay pensions and other benefits after the period end. The ability of the Fund's contributions and investments to meet its overall obligations is reviewed in detail by a firm of independent actuaries.
10. The Fund excludes transactions for teachers, lecturers and youth workers which are administered by the Department for Education and Skills, to whom the Council makes a payment for this purpose.
11. The accounts are prepared on an accruals basis with the exception of inter-fund adjustments (i.e. transfers to and from other pension funds when employees leave and join), which are accounted for on a cash basis.

4.2 Pension Fund Accounts 2005/06

FUND ACCOUNT	2005/06	2004/05	Note
	£'000	£'000	
INCOME			
Employers' Contributions	15,956	9,128	2
Employers' Contributions-Early Retirements	1,692	809	3
Employees' Contributions	4,921	4,662	2
Transfer Values Received	8,806	5,473	
Other Income	26	5	
TOTAL INCOME	31,401	20,077	
EXPENDITURE			
Benefits Payable			
Pensions	10,312	9,766	4
Lump Sums	2,017	1,397	5
Payments to Leavers			
Refund of Contributions	76	165	
Transfer Values Paid	6,193	6,518	
Pension Administration and other expenses	378	336	6
TOTAL EXPENDITURE	18,976	18,182	
NET ADDITION	12,425	1,895	
Returns on Investments			
Investment Income	8,734	7,220	7
Change in Market Value (Realised and Unrealised)	70,448	24,348	
Taxation (Irrecoverable Withholding Tax)	(141)	(121)	
Investment Management Expenses	(1,117)	(1,008)	
Net Returns on Investments	77,924	30,560	
Net Increase (Decrease) in the fund during the year	90,349	32,455	
Opening Net Assets of the Fund	288,166	255,711	
Closing Net Assets of the Fund	378,515	288,166	

4.3 Net Assets Statement

	2005/06		2004/05		Note
	%	£'000	%	£'000	
Investment Assets					8-12
<u>Fixed Interest</u> - UK Public Sector	7.6	28,805	8.9	25,775	
<u>Index Linked Bonds</u> - UK Public Sector	6.3	23,802	8.4	24,133	
- Overseas Public Sector	0.6	2,423	0.0	0	
- Corporate Bonds	0.5	1,715	0.6	1,660	
<u>Equities</u> - UK.	31.0	117,382	32.8	94,382	
- Overseas	34.0	128,694	31.1	89,591	
<u>Pooled Investment</u> - Overseas Equities	6.4	24,281	5.9	17,011	
<u>Vehicles</u> - Corporate Bonds	6.7	25,286	8.0	22,964	
<u>Internal Loans</u>	0.0	0	0.0	5	
<u>Cash on Deposit</u> - Sterling	10.5	39,587	3.7	10,693	
- Currency	(4.0)	(14,971)	0.2	653	
Subtotal		377,004		286,867	
Net debtors/creditors	0.4	1,511	0.4	1,299	13
Net Current Assets and Liabilities	100	378,515	100	255,711	

4.4 Notes to the Pension Fund Accounts

1. The latest actuarial valuation report received is as at 31 March 2004 and was conducted on the following basis:

(a) The market value of the scheme's assets at 31 March 2004 was £255.7 million.

(b) The actuarial valuation, done using the projected unit method, is based on economic and statistical assumptions, the main ones being: -

- i. 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.
- ii. Future rises in pensionable pay due to inflation etc., and pension increases.
- iii. Withdrawals from membership due to mortality, ill health and ordinary retirement.
- iv. Progression of pensionable pay due to promotion.

(c) The contribution rate is set on the basis of the cost of future benefit accrual, increased to bring the funding level back to 100% over a period of 12.5 years, as set out in the Funding Strategy Statement.

(d) On the basis of a funding level of 78%, the employer's common contribution rate is set at 20.5% of pensionable pay from 1 April 2005 to 31 March 2008. Monetary amounts have been set for those employers with no employee members.

The next actuarial revaluation of the Fund will be as at 31st March 2007.

2. Contributions were received from the following sources:

Body	Employers £'000's	Employees £'000's
RBKC	14,160	4,209
Admitted Bodies	1,364	522
Scheduled Bodies	280	105
Schools	152	85
Total	15,956	4,921

3. The Contributions receivable from employers relating to early retirements will vary from year to year, depending on the number of early retirements and the ability to compensate the Fund within each year's budget.
4. Benefits payable were as follows (includes all pension and lump sum payments):

Body	£'000
RBKC	11,836
Admitted Bodies	468
Scheduled Bodies	25
Total	12,329

5. Lump sum payments are summarised as shown below:

Payment Type	£'000
Commutation of pensions and lump sum retirement benefits	1,662
Lump sum death benefits	355
Total	2,017

6. Related Party Transactions

Pension Administration and other expenses were £378k and included the costs of administering pension entitlements, contributions etc, the

apportioned costs of Corporate Finance time spent on pension administration as well as direct costs.

There were no material transactions between the fund and Members of the Investment Committee or between the Fund and senior officers of the Council during the financial years 2004/05 and 2005/06.

7. Summary of Investment Income

	2006 £'000	2005 £'000
Income from Fixed Interest Securities	1,290	1,263
Income from Index Linked Securities	652	597
Dividends from Equities	6,077	5,023
Interest on Cash Deposits	715	458
Subtotal	8,734	7,341
Income from Pooled Investment Vehicles*	1,913	1,442
Total Investment Income	10,647	8,783

* Income from these vehicles is re-invested by the Investment Managers, so is shown in the Fund Account as part of the change in market value.

8. None of the UK Equities is unlisted. The scheme has no material holdings of unlisted investments in other markets
9. Pooled Investment Vehicles (previously known as Managed Funds) are Open Ended Investment Companies investing in equities and bonds.
10. As at 31/03/2006 the fund held open currency hedge positions as follows:-

Alliance Bernstein £182k (net unrealised loss)

Prudential M&G £21k (net unrealised loss)

11. Statement of Investment Principles

The Investment Committee regularly reviews its Statement of Investment Principles (SIP), which is revised following any change in circumstances. A copy of the latest version is published on the Council's web site www.rbkc.gov.uk or obtained from the Executive Director for Finance, Information Systems and Property.

12. Investments

The market value of assets under management at 31 March was as follows:

Managed by	2006		2005	
	£ ' 000	% of Total	£ ' 000	% of Total
Baillie Gifford	134,188	35.6	97,723	34.1
Alliance Bernstein	141,042	37.4	106,666	37.2
Prudential M and G	82,049	21.8	74,872	26.1
Total Managers	357,279	94.8	279,261	97.4
RBKC Cash Inv*	19,725	5.2	7,606	2.6
Total	377,004	100	286,867	100

* Interest on cash held internally is calculated at market rates of interest and credited to the Pension Fund.

The level of activity in the Fund's investments during 2005/06 was as follows:

At Cost	2005/06	
	£'000	£'000
Investments at 1 April		240,631
Purchases	92,550	
Sales Proceeds	(72,840)	
Net Profit *	13,572	33,282
Investments at 31 March		273,913

*Note Sales proceeds less the value of sales at book cost.

13. Net Current Assets

(a) Amounts due to and from the Fund at the balance sheet date have been included within the Fund Account as follows: -

<u>Creditors</u>	£'000
Managers and Fund Measurement Fees	304
Tax on refunded pension contributions	10
Total Creditors	314
<u>Debtors</u>	£'000
Dividends and interest	1,138
Accrued contributions and payments in advance	653
Tax on overseas dividends	34
Total Debtors	1,825

14. There are no material contingent liabilities.

15. Admitted and Scheduled Bodies:

Admitted Bodies

Chelsea Community Association
Housing Action Centre
Kensington Housing Trust
Specialist Schools and Academies Trust
Tenant Management Organisation
West London Family Service Units
Westway Development Trust
Medequip

Scheduled Bodies

Kensington and Chelsea College
St Charles RC 6th Form College

Sue Beauchamp MA CPFA

Executive Director for Finance, Information Systems and Property