

The Royal Borough of Kensington and Chelsea

**Pension Fund
Report and Accounts
2006/07**

September 2007

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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 which up to and including this financial year have managed this function internally. From September 2007, the majority of administration is to be provided by an external company, Capita Hartshead.

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). There are two equity managers operating with different investment styles: Baillie Gifford (growth style bias) and Alliance Bernstein (value style bias). Prudential M&G manage a specialist bond portfolio while in July 2006 approximately five per cent of the Fund was invested in the Osiris property fund of funds, managed by ING. From January 2007, the Fund began investing in a private equity fund of funds run by Adams Street Partners, with a target allocation of five per cent of the Fund, though this currently represents less than 0.2 per cent.

Specific investment benchmarks, aligned to the Fund's investment objectives, are set for each of the managers along with an out-performance target. For managers investing for the whole of 2006/07, these were +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 Institutional 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).

From the beginning of 2006/07, the Fund has also had 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.

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 Catholic Sixth Form College	Westway Development Trust
	West London Family Service Units
	Maxilla Nursery
	Portobello Business Centre
	Housing Action Centre
	Mediquip

The Actuary carried out a cessation valuation on behalf of the Kensington Housing Trust which withdrew from the Fund during the year by making a payment to cover the back-funding element of contributions for its deferred pensioners. Chelsea Community Association has left the Fund, since there are no longer any active, deferred or pensioner members remaining from the organisation.

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 2006/07 were based on the 2004 valuation.

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 were 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 indicated that there should be a significant improvement in the funding level, due to the better than expected performance of the Fund's investments during the year. 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 2006/07 was the fourth complete year of operation under the revised mandates for the equity and bond managers. 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 of 30% bonds and 70% other investment assets was envisaged, with the fund being “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. Hymans Robertson were appointed to consult on the selection process and selected shortlists of potential managers for interview. The process was concluded during the 2006/07 financial year with the appointment of ING to provide an allocation in its Osiris property fund of funds and Adams Street Partners for the private equity fund of funds element.

The Fund was not formally rebalanced during 2006/07, but £18,000,000 from the Fund’s cash balances were used to purchase the property investment and an initial stake of £870,000 has been purchased in the private equity fund of funds. As at 31 March 2007, the Fund was invested 23.9 per cent in bonds and cash and 71.5 per cent in equity investments and 4.6 per cent in property.

Removal of the tax credit on UK dividends in 1998 continues to affect the Fund’s income adversely. It continues to cost the Fund around £1 million each year.

Councillor John Cox

Chairman of the Investment Committee

July 2007

3 Investment Performance

3.1 Fund Manager Performance 2006/07

The Property and Private Equity elements have been in the portfolio for less than a year, so no meaningful data can be reported.

The performance of the individual managers and the Fund as a whole, compared to the composite index-based customised benchmark, is as follows:

Manager	Benchmark	Performance	Difference	Notes
Alliance Bernstein	8.3 <i>(31.6)</i>	9.6 <i>(32.2)</i>	+1.3 <i>(+0.6)</i>	1
Baillie Gifford	8.3 <i>(31.6)</i>	5.1 <i>(37.4)</i>	-3.2 <i>(+5.8)</i>	1
Prudential M&G	0.4 <i>(10.0)</i>	0.7 <i>(9.7)</i>	+0.3 <i>(-0.3)</i>	2
Total Fund	6.1 <i>(24.9)</i>	5.6 <i>(28.0)</i>	-0.5 <i>(+3.1)</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 three of the managers have been investing on the Fund's behalf for over three years, it is possible to compare their performance over the full period:

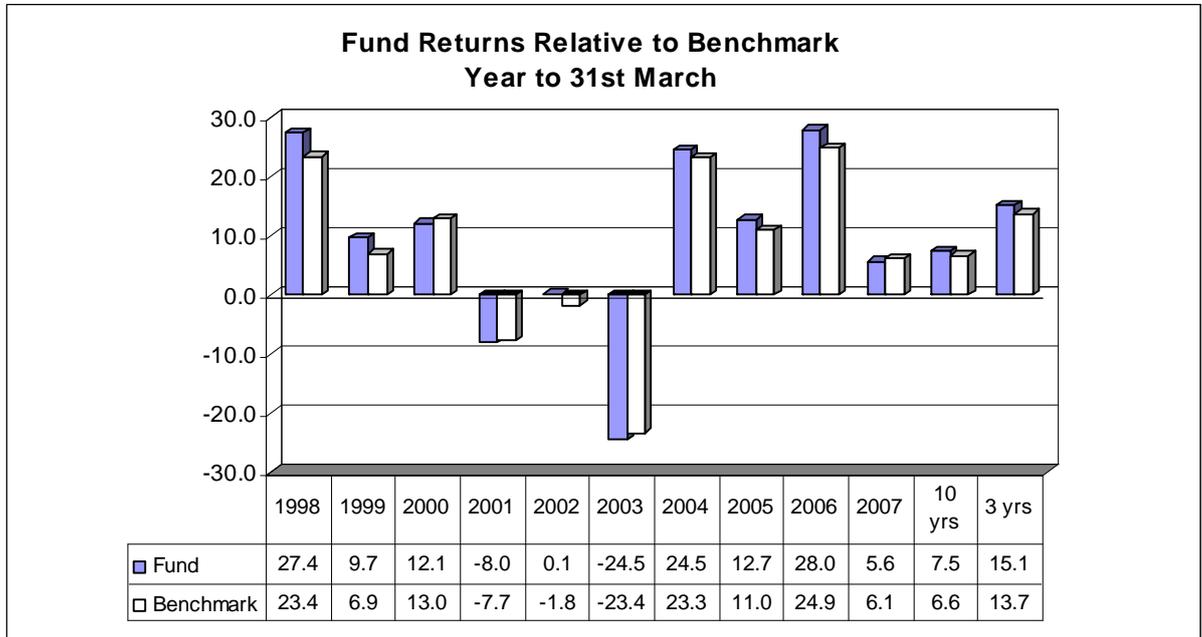
Manager	Benchmark	Performance	Difference	Notes
Alliance Bernstein	17.3 <i>(25.2)</i>	19.4 <i>(27.8)</i>	+2.1 <i>(+2.6)</i>	1
Baillie Gifford	17.3 <i>(25.2)</i>	17.5 <i>(25.9)</i>	+0.2 <i>(+0.7)</i>	1
Prudential M&G	5.4 <i>(7.0)</i>	5.6 <i>(7.3)</i>	0.2 <i>(+0.3)</i>	2
Total Fund	13.7 <i>(19.6)</i>	15.1 <i>(21.4)</i>	+1.4 <i>(+1.8)</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

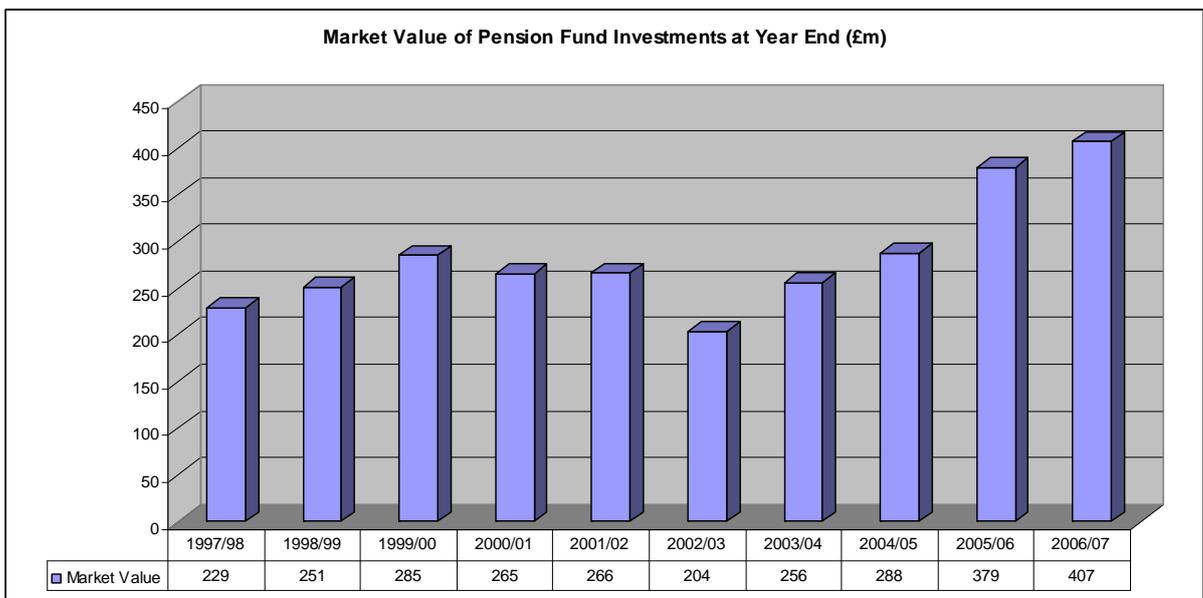
3.3 Long Term Fund Performance – 10 years

The performance of the Fund over the past 10 years is shown below (note that benchmarks and managers changed with effect from 2003).



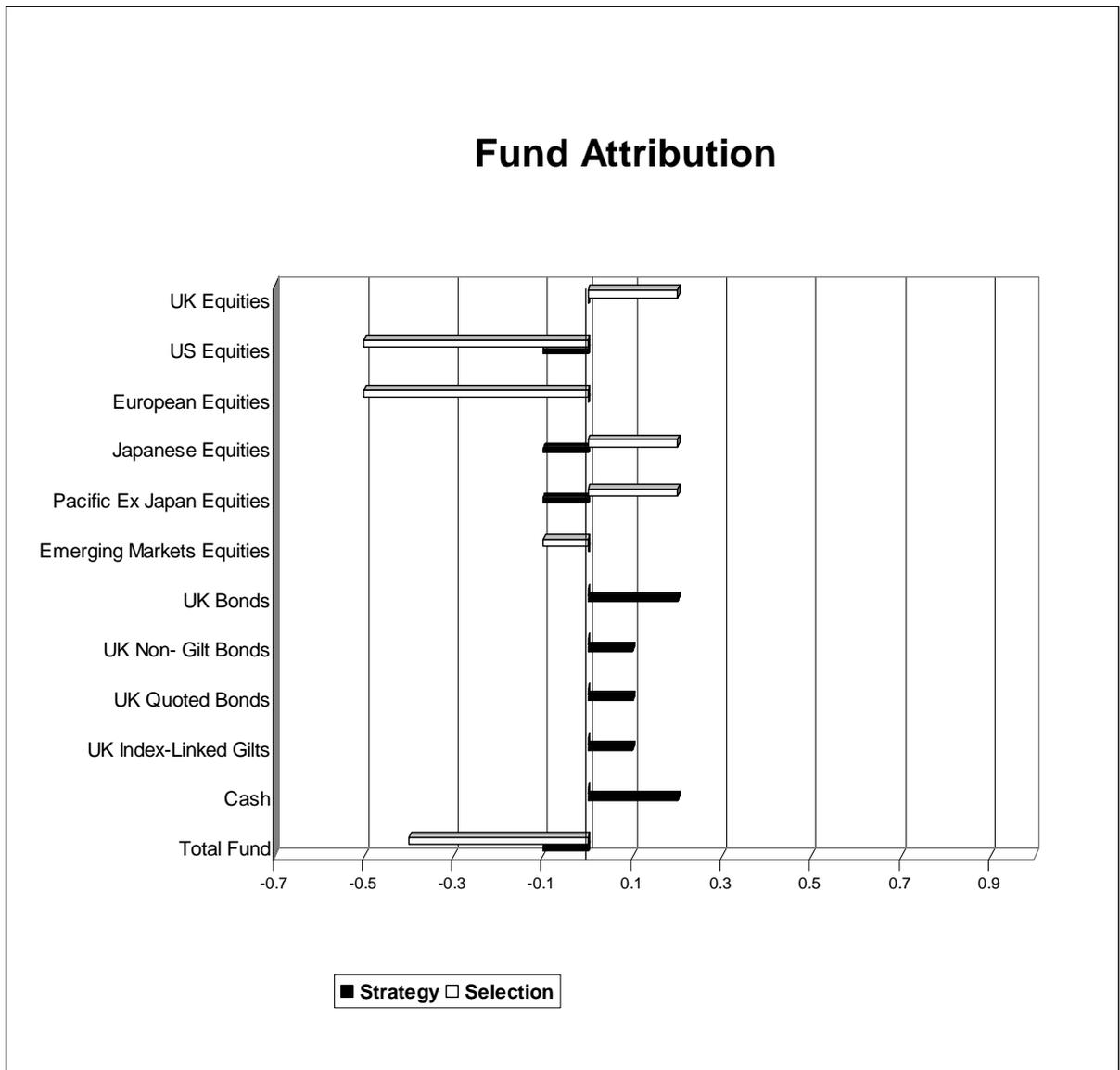
3.4 Market Value of the Fund – 10 years

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 2007

Over the year, the return for the Fund was 5.6% and the benchmark return was 6.1%. Sector level attribution is shown in the following table:

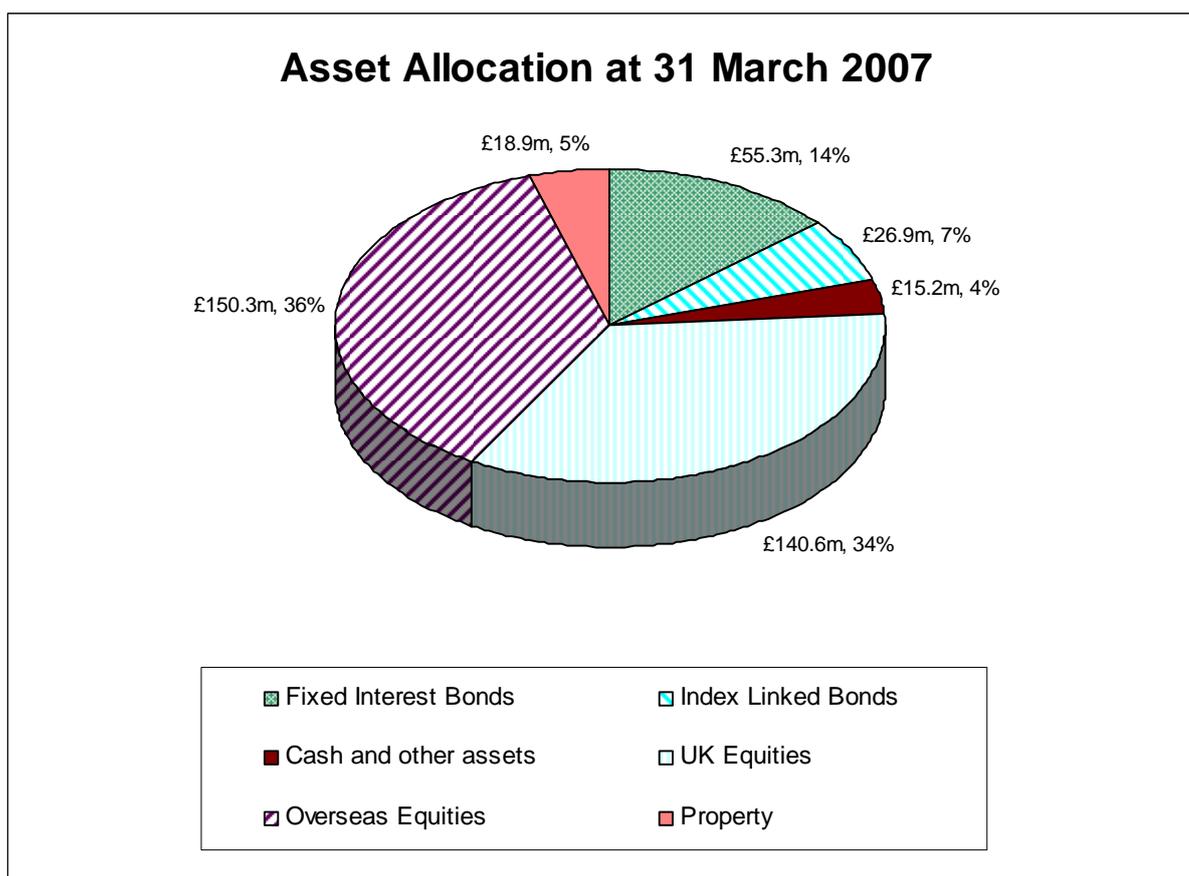


Strategy relates to the allocation of investments in each sector while selection refers to the individual stocks chosen within that sector.

3.6 Asset Allocation

The asset allocation at the 31st March 2007 was as follows:

The total market value of the Fund held in equities (including private equity) was 71.4% at 31 March 2007, together with 4.6% in property . Bonds made up 20.2%, and cash and other assets 3.7%.



3.7 Turnover During The Year

Turnover during 2006/07 was higher than in 2005/06 as more sales were made than in the previous year which, with the high level of dividend income, increased re-investment opportunities.

Investments At Cost	2006/07	2005/06
	<i>£'000</i>	<i>£'000</i>
Purchases	136,631	92,550
Sales – Actual	119,995	72,840
Total Turnover	256,626	165,390

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:

	2007	2006
Active Members	3,359	3,206
Pensioners and Dependents	2,056	2,036
Former Employees - Deferred Benefits	2,701	2,515
Total	8,116	7,757

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. The property fund of funds is valued at the valuation price quoted for 31 March. The private equity investment is currently valued at its cash cost, since valuation reports are received three months after the period end, after the closing period (investment commenced in January 2007). In future years, the December valuation will be used with a cash value for the last quarter.

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 2006/07

FUND ACCOUNT	2006/07	2005/06	Note
	£'000	£'000	
INCOME			
Employers' Contributions	17,920	15,956	2
Employers' Contributions-Early Retirements	607	1,692	3
Employees' Contributions	5,270	4,921	2
Transfer Values Received	3,241	8,806	
Other Income	3	26	
TOTAL INCOME	27,041	31,401	
EXPENDITURE			
Benefits Payable			
Pensions	11,041	10,312	4
Lump Sums	3,264	2,017	4,5
Payments to Leavers			
Refund of Contributions	66	76	
Transfer Values Paid	3,905	6,193	
Pension Administration and other expenses	401	378	6
TOTAL EXPENDITURE	18,677	18,976	
NET ADDITION	8,364	12,425	
Returns on Investments			
Investment Income	9,878	8,734	7
Change in Market Value (Realised and Unrealised)	11,815	70,448	
Taxation (Irrecoverable Withholding Tax)	(185)	(141)	
Investment Management Expenses	(1,207)	(1,117)	
Net Returns on Investments	20,301	77,924	
Net Increase (Decrease) in the fund during the year	28,665	90,349	
Opening Net Assets of the Fund	378,515	288,166	
Closing Net Assets of the Fund	407,180	378,515	

4.3 Net Assets Statement

	2006/07		2005/06		Note
	%	£'000	%	£'000	
Investment Assets					8-12
<u>Fixed Interest</u> - UK Public Sector	7.4	30,042	7.6	28,805	
<u>Index Linked Bonds</u> - UK Public Sector	6.2	25,205	6.3	23,802	
- Overseas Public Sector	0.0	0	0.6	2,423	
- Corporate Bonds	0.4	1,722	0.5	1,715	
<u>Equities</u> - UK	34.5	140,618	31.0	117,382	
- Overseas	30.8	125,466	34.0	128,694	
<u>Pooled Investment</u> - Overseas Equities	5.9	23,992	6.4	24,281	
<u>Vehicles</u> - Corporate Bonds	6.2	25,260	6.7	25,286	
<u>Property</u>	4.7	18,890	0.0	0	
<u>Private Equity</u>	0.2	874	0.0	0	
<u>Cash on Deposit</u>	3.3	13,407	6.5	24,616	
Subtotal		405,476		377,004	
Net debtors/creditors	0.4	1,704	0.4	1,511	13
Net Current Assets and Liabilities	100	407,180	100	378,515	

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	14,661	4,368
Admitted Bodies	2,576	652
Scheduled Bodies	474	138
Schools	209	112
Total	17,920	5,270

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	13,664
Admitted Bodies	607
Scheduled Bodies	34
Total	14,305

5. Lump sum payments are summarised as shown below:

Payment Type	£'000
Commutation of pensions and lump sum retirement benefits	3,007
Lump sum death benefits	257
Total	3,264

6. Related Party Transactions

Pension Administration and other expenses were £401k 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 2005/06 and 2006/07.

7. Summary of Investment Income

	2006/07 £'000	2005/06 £'000
Income from Fixed Interest Securities	1,419	1,290
Income from Index Linked Securities	642	652
Dividends from Equities	6,908	6,077
Income from Property Fund of Funds	237	0
Interest on Cash Deposits	672	715
Subtotal	9,878	8,734
Income from Pooled Investment Vehicles*	1,466	1,913
Total Investment Income	11,344	10,647

* 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 March 2007 the fund held open currency hedge positions as follows:-

Alliance Bernstein £156k (net unrealised profit)

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 can be 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	2007		2006	
	£ ' 000	% of Total	£ ' 000	% of Total
Baillie Gifford	140,543	34.6	134,188	35.6
Alliance Bernstein	153,621	37.9	141,042	37.4
Prudential M and G	82,608	20.4	82,049	21.8
ING	19,012	4.7	0	0.0
Adams Street Partners	874	0.2	0	0.0
Total Managers	396,658	97.8	357,279	94.8
RBKC Cash Inv*	8,818	2.2	19,725	5.2
Total	405,476	100	377,004	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 2006/07 was as follows:

At Cost	2006/07	
	£'000	£'000
Investments at 1 April		273,914
Purchases	136,631	
Sales Proceeds	(119,995)	
Net Profit *	20,174	36,810
Investments at 31 March		310,724

*Note Sales proceeds less the value of sales at book cost. This excludes an unrealized loss of £8,359k, making a total of £11,815k.

The total change in market value of investments during the year comprises all increases and decreases in the market value of investments held at any time during the year, including profits and losses on sales of investments during the year.

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	331
Accrued lump sum payments	115
Total Creditors	446
<u>Debtors</u>	£'000
Dividends and interest	272
Accrued contributions and payments in advance	1,793
Tax on overseas dividends	85
Total Debtors	2,150

14. There are no material contingent liabilities.

15. Admitted and Scheduled Bodies:

Admitted Bodies

Housing Action Centre
 Maxilla Nursery
 Mediquip
 Portobello Business Centre
 Specialist Schools and Academies Trust
 Tenant Management Organisation
 West London Family Service Units
 Westway Development Trust

Scheduled Bodies

Kensington and Chelsea College
 St Charles Catholic 6th Form College

16. **Additional Voluntary Contributions (AVCs)**

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 do not permit AVCs to be paid into the pension fund, so they are not included in these accounts. The Council has made arrangements for current members to make additional payments through its payroll into a variety of funds operated by Prudential Assurance according to individuals' preferences. These funds are invested in equities, bonds, property and cash. A total of £201k was invested by members of this fund in this way during 2006/07.

Sue Beauchamp MA CPFA

Executive Director for Finance, Information Systems and Property

