SUBJECT:	**Investment Performance Quarter Ending 31st December 2012**
REPORT OF:	**Officer Management Team - Director of Resources** **Prepared by – Principal Accountant**

1. Purpose of Report

1.1 To inform Members of the investment returns for the quarter ending 31st December 2012 and update Members on the progress of investigating corporate bonds/corporate bond funds.

2. Links to Council Policies & Plans

2.1 The Council's Treasury Management function is a key element to the Financial Strategy, which in turn feeds into the prudent use of Resources, one of the Council's Management Principles.

3. Background

3.1 The Council's Treasury Management Strategy 2012/13 details the following sources for generating investment income for the year:

(i) Set an estimated return on investment income for the year of £0.8 million.

(ii) Set the sources for generating income for the year as follows:

	£'000
Fixed & Callable Deposits	657
Short Term Cash Flow and Other Investments	77
Stoke Poges Memorial Gardens Fund	66
Total	800

3.2 In addition Sector Treasury Services Ltd is engaged by the Council as its Treasury Management consultants providing advice on investment, performance and regulations where necessary.

3.3 The Council has adopted the CIPFA code of practice on Treasury Management, which includes the creation of a Treasury Management Policy Statement setting out the policies and objectives of the Council's treasury management activities.

3.4 The code recommends that reports on investment performance are made on a quarterly basis including a Mid-year Review Report. This report represents the third of these reports for 2012/13.

4. Investment Performance – Quarter to 31 December 2012.

4.1 **<u>In House Investments</u>** – Officers invest cash flow surpluses with approved counter parties. Decisions on investing in callable and fixed deposits are taken by Officers in the light of advice from the Council's treasury consultants and brokers acting in the local authority money market, combined with general intelligence available from money market briefings made available to the authority. Members approved a new matrix for in house investments as part of the Treasury Management Strategy 2012/13 as follows.

	Fitch Credit Rating	Maximum Amount	Comment
UK Institutions	AAA	£10 million	The durations of the investment would be informed by the detailed credit rating information
	A+ or better	£7 million	
	A or better Banks with high UK Gov Support	£7 million	
	A or A-	£2 million	
Non UK Institutions	AA or better	£2 million	As above but also sovereignty rating must be AAA
Corporate Bonds	AA- or better	£2 million	Investment decision will be based on balancing yield against duration

4.2 A summary of the Council's holdings of fixed deposits at 31st December 2012 is shown below:

UK Institutions	Credit Rating	Maximum Amount £7 Million Principal £	Interest Rate	Invested	Matures	Notes
Royal Bank of Scotland	A					
Fixed Deposit		5,000,000	4.25%	08/02/12	08/02/17	(1)
Fixed Deposit		2,000,000	3 Month Libor	02/06/11	02/06/14	(2)
Total RBS		7,000,000				
Cater Allen	A					
Fixed Deposit		1,000,000	3.50%	21/07/10	21/07/13	
Fixed Deposit		2,000,000	3.20%	30/09/10	30/09/13	
Total CA		3,000,000				
Lloyds Bank	A					
Fixed Deposit		1,000,000	3 Month Libor, Floor 2.85%, Cap 5.85%	11/05/10	12/05/15	
Fixed Deposit		1,000,000	3 Month Libor, Floor 3.07%, Cap 5.00%	19/05/10	19/05/15	
Total Lloyds Group		2,000,000				
Barclays	A					
Fixed Deposit		1,000,000	3 Month Libor, Floor 3.05%, Cap 5.00%	24/05/10	26/05/15	
Total Barclays		1,000,000				
Close Brothers						
Fixed Deposit		1,000,000	2.80%	04/10/12	04/10/13	
Total Close Brothers		1,000,000				
Total Deposits		14,000,000				

(1) RBS have the option to switch to 3 month LIBOR[1] in years 3, 4 & 5.

(2) RBS have exercised their option to switch to 3 month LIBOR in year 2.

4.2 In addition the Council held the following investments of short term cash with duration of under one year at the end of the quarter:

	Fitch	Amount £	Interest Rate	Period
Nat West Bank	A	4,262,000	Base + 28 Basis Points	Instant Access
Nat West Bank	A	3,500,000	Base + 47 Basis Points	30 Day Notice Account
Nat West 95 Day Notice	A	1,000,000	1.20%	02/11/12 to 11/02/13
Nat West 95 Day Notice	A	1,000,000	1.20%	20/11/12 to 25/02/13
Bank of Scotland	A	1,000,000	3.00%	23/04/12 to 11/04/13
Bank of Scotland	A	1,000,000	2.00%	15/05/12 to 15/02/13
Bank of Scotland	A	3,000,000	3.00%	16/07/12 to 04/07/13
Bank of Scotland	A	1,000,000	1.75%	27/09/12 to 14/02/13
Bank of Scotland	A	1,000,000	1.15%	20/11/12 to 20/02/13
Close Brothers	A	1,000,000	2.10%	22/05/12 to 22/02/13
Total		17,762,000		

Since 31st December 2012 the following investment action has taken place:

The following maturities have taken place

	Amount £	Matured	Interest Rate
Nat West 95 Day	1,000,000	11/02/13	1.20%
Nat West 95 Day	1,000,000	25/02/13	1.20%
Bank of Scotland	1,000,000	15/02/13	2.00%
Bank of Scotland	1,000,000	14/02/13	1.75%
Bank of Scotland	1,000,000	20/02/13	1.15%
Close Brothers	1,000,000	22/02/13	2.10%
	6,000,000		

The following new investments have been made

Long Term (in excess of one year)

	Fitch	Amount £	Interest Rate	Period
Close Brothers	A	1,000,000	2.70%	22/02/13 to 22/08/14

Short Term(less than one year)

The remaining maturities have been invested on a very short term basis with Nat West either overnight or in the 30 days notice account in order to meet cash fund requirements, which are particularly high during February and March when precepts are still required to be paid but income from Council Tax and NNDR is low due to the collection period of the first 10 months of the year, and to have available cash for long term investments once Members have made a final decision on the issue of investing in corporate bonds or corporate bond funds.

[1] LIBOR – London Inter Bank Offered Rate

4.3 **Stoke Poges Memorial Gardens Fund:** The interest return from the fund is no longer credited directly to the Stoke Poges Memorial Gardens cost centre but has been incorporated with all of the Council's other investment returns.

4.4 The fund is managed on a passive basis by King & Shaxson. The value of the fund at 31st December 2012 was £1,367,968.58.

5. Treasury Management Strategy Update – Progress on Investing in Corporate Bonds/ Corporate Bond Funds

5.1 The Treasury Management Strategy (TMSS) 2013/14 was approved by the Council on 26th February 2013. The TMSS 2013/14 includes the following recommended action is taken:

Approved a new counterparty matrix which is shown below and includes a minimum credit rating for investments of up to 3 years of BBB+ and for Corporate Bonds/Corporate Bond Funds a minimum credit rating for investing of A-

	Duration	Maximum Amount	Fitch Rating	Comment
UK Institutions	Up to 5 years	£5m	A- or better	
	Up to 3 years	£5m	BBB+ or better	
Non UK Institution	Up to 3 years	£2m	A- or better	Sovereignty rating AA or better
Corporate Bonds/Bond Funds	Up to 5 years	£5m	A- or better	

In addition Officers were asked to investigate the diversification of up to £5 million of the investment portfolio into Corporate Bonds/Corporate Bond Funds or index linked Gilts.

5.2 A list of available UK corporate bonds with a yield of approximately 2.50% and above and which meet the Council's credit rating and duration is attached at appendix C.

5.3 With regard to investing in a corporate bond fund there are a range of these and early research indicates that most (if not all) are not rated as such but deal in investment grade instruments which will go down to BBB, therefore risk maybe spread over a range of investments from BBB to AAA and therefore may not meet the approved counterparty matrix above, there may also be a minimum level of investment and fund management fee. Officers have been in contact with Sector and the Bucks County Council Pension Fund to obtain suggested names that are used by local authorities and will then carry out further research with regard to credit quality, yield, duration, minimum level of investment and management fees and if any further information is available an update will be given at the meeting.

5.4 Investment in individual corporate bonds does have the following advantages:

- It would have a known rate of return and duration period.
- There would be no minimum investment level and the £5 million could be spread over a number of bonds.
- There would be no fund manager selection process and investment and diversification of the investment portfolio could be achieved earlier in 2013/14.

- There would be no ongoing fund manager fees.
- The Council would have more control e.g. the Council would make the investment decision including the rating of the counterparty when entering the investment whereas a bond fund would probably not be rated and would spread the risk over a number of counterparties some of which would be below the credit rating within the Council's matrix.

5.5 At the last meeting of this PAG when the TMSS 2013/14 was approved some Members expressed the view that equities/equity funds should not be excluded from consideration. I have researched the use of equities further and as a result of my investigations have produced the following:

For the direct investment into equities the expenditure would be classified as capital. Any proceeds from the sale would be a capital receipt. A dividend payment, if distributed, would be revenue. Therefore direct investment in equities, whilst possibly achieving an element of capital growth, would likely result in reducing the amount of revenue interest in the year and have an impact on the level of council tax.

If the Council invested in an equity fund it would need to be determined if this was capital expenditure or avoided the classification as a result of being in a fund. Investing in an equities fund would mean the buying of units and changes in the unit value would be made up of increase/decrease in equity values and any dividend distribution. If the split on the unit value was not known it could result in movements in share value going through Income & Expenditure (even where they are unrealised)

To carry out this sort of accounting we would need to classify the fund as Fair Value through Profit or Loss and have evidence of trading as defined in the CIPFA Code of Practice on Local Authority Accounting.

If the fund didn't meet the classification it would be Available for Sale and there would be a need to get a break down to determine whether the gains/losses within the unit values are all realised. If there are any unrealised gains or losses at year end they should be held on the balance sheet in the Available for Sale Reserve and not taken to the Income & Expenditure account until they are realised.

There would always be a risk that if the fund is deemed capital, any gains or losses taken to revenue would have to be unwound and recognised as net capital receipts.

6. Economic Background

6.1 During the quarter ended 31st December 2012

- Indicators suggested that the economy probably contracted;
- Retail sales weakened but spending off the high street held up;
- Employment continued to rise, albeit at a slower pace;
- Inflation remained stubbornly above the MPC's 2% target;
- The MPC paused its programme of asset purchases;
- UK equity prices rose and government bond prices fell;
- The US economy continued to recover at a modest pace.

A more detailed Economic Background is shown at appendix A.

7 Interest Rate Forecasts

7.1 The latest forecast for interest rates provided by Sector is shown below:

	Jun 13	Sep 13	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14	Mar 15	Jun 15	Sep 15	Dec 15	Mar 16
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%

Sector undertook a review of its interest rate forecasts following the issue of the Bank of England Inflation Report for November 2012. In the August Inflation Report, the Bank changed its position significantly in as much as it markedly downgraded its forecasts for the strength and speed of recovery in GDP growth whereas previously it had consistently been forecasting a strong recovery to over 3%p.a. In its November Report, the Bank has continued to shift towards pessimism in the speed and strength of recovery; it is now only forecasting growth at around 1% in 2013 and 2% in 2014. These developments have pushed back Sector's expectations of the timing of the eventual start of increases in Bank Rate from Q4 2014 to Q1 2015, as well as the pace of rises in gilt yields.

A more detailed summary outlook on the prospects for interest rates is shown at appendix B

8. Resources, Risk & Other Implications

8.1 The investment budget set for the current year is £800,000. Latest estimated returns show that there is likely to be a shortfall of £25,000 for the year which has been reflected in budget monitoring reports.

9. Recommendation

9.1 The PAG is requested to note the investment performance for the quarter to 31st December 2012.

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Background Papers:	**None**