HAMPSHIRE COUNTY COUNCIL

Report

Decision Maker:	Audit Committee
Date:	23 July 2020
Title:	Higher yielding strategy update
Report From:	Deputy Chief Executive and Director of Corporate Resources

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Purpose of the Report

1. The County Council invests a proportion of core balances in investments targeting yields of 4% to support the Council's revenue budget. This report provides an update on the performance and ongoing review and scrutiny of these investments.

2. This report has been written in response to a request from Members at the last meeting of the Audit Committee in February 2020 to provide further information on investment management and the County Council's investments targeting higher yields.

Recommendations

3. The Audit Committee are asked to note the contents of this report.

Executive Summary

4. The County Council holds a portfolio of investments of £201.2m targeting higher yields of around 4% per annum. These investments have been made from the County Council's most stable investment balances and have been made in line with the requirements of the CIPFA Code, whereby the County Council must have regard to the security and liquidity of its investment balances before seeking the highest yield.

5. The County Council is advised on its investment decisions by its treasury management advisor, Arlingclose, and after considering its treasury management options has invested in a diversified range of pooled investment vehicles as well as a number of long term deposits and bonds.

This diversification helps to mitigate the risks associated with holding these investments.

6. The County Council's objective is to deliver income returns of around 4% each year. As such it invests in income distributing share classes of pooled funds that are designed to provide the level of income required. The County Council is not therefore investing with the primary objective of achieving capital growth, although all of the funds in which it is invested aim to deliver some degree of capital growth alongside the targeted income returns.

7. Having reviewed and rejected alternative options, it is important for the County Council to continue to monitor the effectiveness of its investments in pooled funds and their ongoing suitability. This is achieved through monitoring and scrutiny conducted by officers alongside the ongoing review, due diligence, and advice provided by Arlingclose.

8. Since the inception of the higher yielding strategy, and particularly since the amount earmarked to the strategy was increased to £200m in 2017, these investments have delivered a significant positive contribution to the County Council's revenue budget.

9. The County Council's investments in pooled funds have generated an annualised income return of 4.57%. This equates to over £24m of dividend and interest payments since 2014, of which £18.8m relates to the last 3 financial years, which has supported the County Council's services and reduced the need for further savings through this period of austerity.

10. The investments in pooled funds suffered reductions in value during March 2020 as markets reacted to the global Coronavirus pandemic. The long term impact has been assessed by Arlingclose, who have provided assurance that they anticipate capital values to recover over the County Council's investment horizon. In addition, the investments are expected to continue to provide the County Council with income returns significantly in excess of what could be achieved from more traditional cash based investments.

The higher yielding strategy

11. The CIPFA Treasury Management in the Public Services: Code of Practice 2017 (the CIPFA Code) requires local authorities to determine a Treasury Management Strategy Statement before the start of each financial year.

12. When setting the Treasury Management Strategy for 2014/15 the County Council was faced with an historically low interest rate environment and decided to earmark part of its cash balances to investments appropriately

targeting higher yields of around 4%, with the aim of increasing the total level of income contributed to the revenue budget.

13. The strategy initially earmarked £105m, with the County Council subsequently agreeing to increase this amount to £200m in 2017 and to £235m in 2019. After analysing anticipated future cash flows this earmark of £235m was maintained as part of the Treasury Management Strategy for 2020/21.

14. The CIPFA Code requires the County Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest yield. As a result, the County Council's investments seeking higher yields have been made from its most stable balances and with the intention that they will be held for at least the medium term. This means that the initial costs of any investment and any periods of falling capital values can be overcome, and mitigates the risk of having to sell an asset for a loss for liquidity purposes, helping to ensure the long-term security of the Council's investment.

15. The authority to make investments under the higher yielding strategy is delegated to the Deputy Chief Executive and Director of Corporate Resources. Decisions will only be made after first taking advice from Arlingclose, the County Council's treasury management advisor.

16. The County Council's current portfolio of investments targeting higher yields is summarised in Table 1.

Table 1

Investment type	**Amount invested**
Fixed bonds	£10.0m
Fixed deposits	£20.2m
Pooled property funds	£77.0m
Pooled equity funds	£52.0m
Pooled multi-asset funds	£42.0m
Total	**£201.2m**

17. Following advice from Arlingclose, the County Council has constructed an investment portfolio that is diversified across asset classes and regions, as

shown in Table 1. This has been achieved by investing in pooled investment vehicles (pooled funds) alongside long term lending to other local authorities, the purchase of long-term bonds and, more recently, loans relating to the Manydown development project. This diversification helps to mitigate the risk of overexposure to a single event affecting a specific asset class. The use of pooled funds has also enabled the County Council to achieve a greater degree of diversification than could effectively have been done by directly owning individual assets. Pooled funds are managed by specialist external fund managers who are best placed to select and manage investments, for example for property investments managing the relationship with tenants and the maintenance of buildings.

18. Diversification in itself does not guarantee positive outcomes. The selection of pooled funds has been carefully managed to target funds with a strong performance track record and objectives that are well aligned to the County Council's aim of achieving income returns of around 4%pa without putting its initial investment at undue risk over the longer term. The County Council is therefore invested in funds that specialise in providing income returns to support the revenue budget. As a result of their income focus these funds may not achieve the same capital growth and therefore total return, as other more general investment funds.

19. The investible universe for pooled funds is vast and part of the service provided by Arlingclose as treasury advisors is to conduct research and suitable due diligence on pooled funds prior to making recommendations to their clients.

20. Past performance does not guarantee that funds can replicate successful outcomes in future and knowing which funds will perform well is not an exact science. The County Council therefore conducts its own ongoing review and scrutiny of the performance of its pooled fund investments. The County Council will also discuss these investments regularly with Arlingclose, who provide advice based on regular meetings with representatives from the pooled funds and their own ongoing due diligence on areas such as performance and investment style, strategy and process.

Other options

21. The County Council has considered and rejected the following alternative investment options when implementing the higher yielding strategy.

Option	**Rationale for rejecting option**
Continue to invest solely in traditional treasury investments such as bank	The County Council has been faced with an historically low interest rate environment for several years. Investing only in less volatile

deposits, money market funds, treasury bills and bonds, and by lending to other local authorities, to reduce risk and give a narrower range of potential investment outcomes	instruments would have resulted in significantly lower investment income which would have increased the savings required from departmental budgets as part of the Council's transformation programmes. The risks associated with investing in more volatile asset classes are mitigated by holding a diversified portfolio of investments with the understanding that these investments will be held for at least the medium term. In addition, investing in pooled funds helps the County Council to avoid the risk of bail-in associated with holding deposits with UK banks.
Invest in directly owned assets such as shares and property with the benefit of avoiding investment management fees associated with pooled funds	The County Council will buy and own individual bonds and make long term loans, however investing in pooled equity, property and multi-asset funds allows the County Council to achieve greater diversification than by investing in individual assets in these areas, reducing the risk to the County Council. This is consistent with Arlingclose's recommendation that the County Council has a diversified investment portfolio. Pooled funds also benefit from specialist external fund managers to select and manage investments. Investment returns are reduced due to fees paid to pooled fund investment managers but the County Council does not have to directly contract and pay specialist asset managers, for example to manage the relationship with property tenants and building maintenance.
Invest in pooled funds seeking greater capital returns	All of the pooled funds in which the County Council is invested aim to generate a positive capital return, but it is not their primary aim. The County Council's objectives are to comply with the CIPFA Code whilst generating income returns to support the revenue budget and preserving the capital balance over the longer term (i.e. generating a total return over the longer term that is greater than cash investments). The pooled funds the County Council has invested in have been recommended by Arlingclose as they are considered to be most suitable for

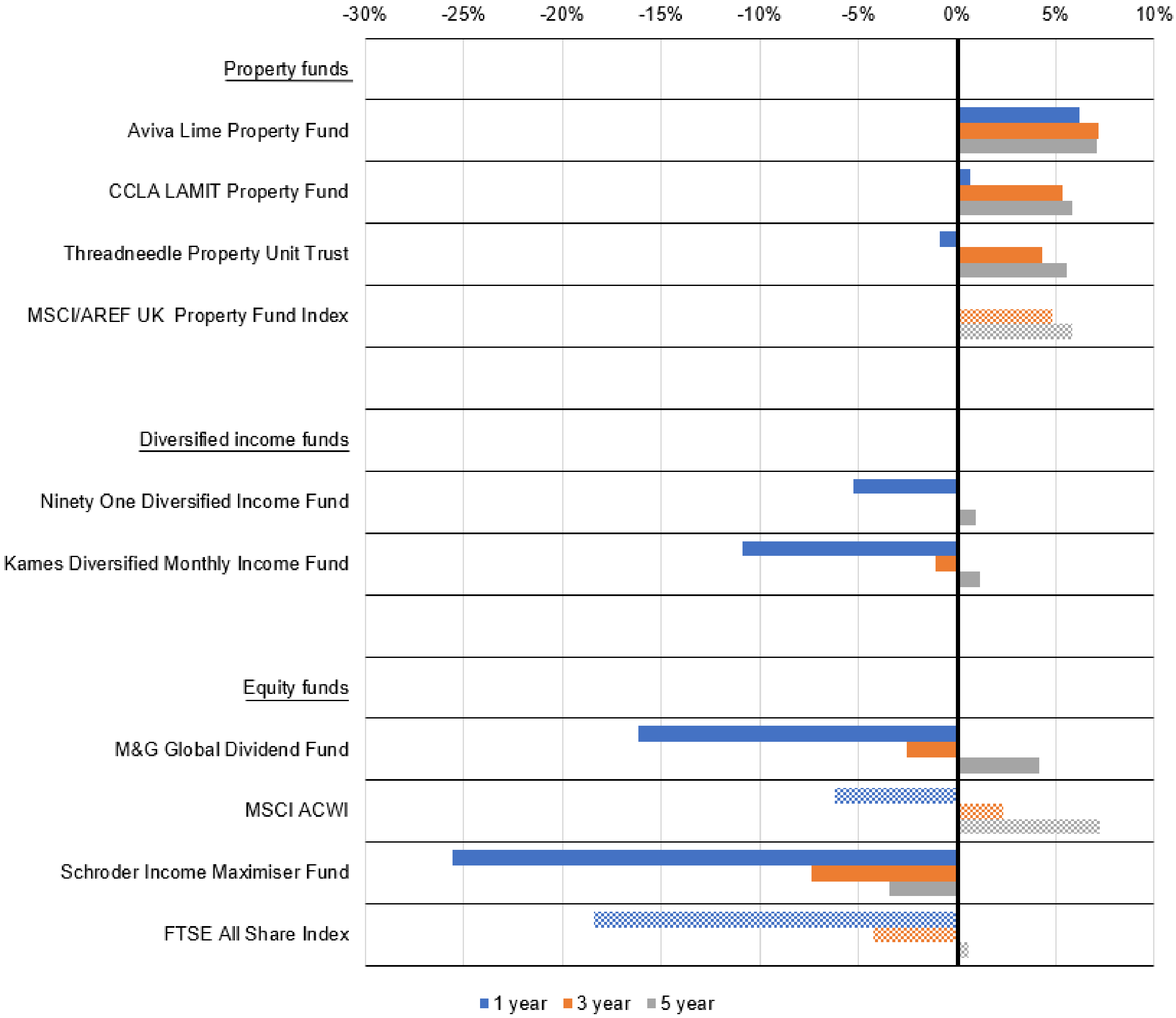
	achieving these objectives. Pooled funds seeking to deliver greater capital growth would not deliver the steady income returns required to support the Council's revenue budget.
Invest in accumulation share classes to target greater capital growth over the longer term	One of the County Council's primary objectives when investing in pooled funds is to deliver regular and relatively stable income to support the revenue budget. The County Council therefore invests in income share classes, which provide regular income but reduce the potential for longer term capital gains.
Invest additional sums in pooled funds to target higher returns instead of pre-paying LGPS employer's pension contributions for 2020/21 to 2022/23 in April 2020.	The payment in advance of pension contributions is expected to generate a saving for the Council, net of investment income foregone on cash balances, of approximately £3m per annum for 3 years. This saving is the result of making one lump sum payment in April 2020 instead of smaller monthly payments. This impacts the County Council's cash flow by varying the timing of the payment of pension contributions but does not have a significant impact on the longer term cash balance. It is effectively the County Council investing money for a 3 year period and having this repaid over that timeframe by not making monthly pension payments. The County Council would not have invested money in pooled funds for a 3 year period. Investing some or all of this money in pooled funds would not have been consistent with the CIPFA Code and would have impacted the County Council's liquidity as pooled fund investments must be considered as long term investments to protect the security of the Council's initial investment.

22. The County Council continues to regularly review the ongoing appropriateness of its investments and discusses alternative options with Arlingclose.

Performance and benchmarking of the higher yielding strategy

23. The County Council has invested in 7 pooled funds as part of the higher yielding strategy and the total return of these funds against relevant comparator benchmarks is shown in Chart 1. This shows that the property funds have generally performed well over the 1, 3 and 5 year periods when compared with the wider market, whereas the equity funds have not matched the benchmark performance. As explained in paragraph 18, income equity funds may underperform the benchmark as they may sacrifice some capital growth to meet their objective of income returns. The diversified funds are not compared to a benchmark as they can invest in a variety of asset classes, but Ninety One and Kames target income returns of 4% and 5% respectively, with the potential for some capital growth.

Chart 1 - Pooled fund performance p.a. over 1, 3 and 5 years at 31/3/20



24. The performance of the County Council's investments in these funds will vary from the fund level performance data shown in Chart 1. This is because the County Council has made investments into these funds at various intervals since 2014 as the higher yielding strategy has evolved. Arlingclose also does not recommend that the County Council tries to time the market when making investments and when the County Council has invested it has therefore done so in tranches to mitigate the risk of buying at the top of the market.

25. Table 2 below shows the income track records of the 7 pooled funds over the same 1, 3 and 5 year periods and demonstrates the consistent levels of income being returned by these funds, which forms part of the assessment of their ongoing suitability by officers and Arlingclose.

Table 2 – pooled fund income returns

	1 year	3 year p.a.	5 year p.a.
Property funds			
Aviva Lime Property Fund	3.81%	3.98%	4.09%
CCLA LAMIT Property Fund	4.24%	4.44%	4.48%
Threadneedle Property Unit Trust	4.70%	4.70%	4.71%
Diversified income funds			
Ninety One Diversified Income Fund	4.13%	3.99%	3.68%
Kames Diversified Monthly Income Fund	4.85%	4.70%	4.48%
Equity funds			
M&G Global Dividend Fund	3.40%	3.13%	3.47%
Schroder Income Maximiser Fund	7.68%	6.82%	6.53%

26. The performance of the County Council's own holdings in these pooled funds is shown in Table 3, broken down between the capital return, the level of income generated, and the total return. It should be noted that the capital return (gain or loss) will only be realised if the County Council sells its investments in these pooled funds.

Table 3 – Pooled fund returns since purchase

Pooled fund	Capital return	Income return	Total return
Aviva Lime Property Fund	5.07%	14.14%	19.21%
CCLA LAMIT Property Fund	-5.47%	17.58%	12.11%
Kames Diversified Monthly Income Fund	-6.24%	6.78%	0.54%
M&G Global Dividend Fund	3.93%	10.74%	14.67%
Ninety One Diversified Income Fund	-6.98%	12.26%	5.28%
Schroder Income Maximiser Fund	-33.34%	18.56%	-14.79%
Threadneedle Property Unit Trust	-6.89%	13.92%	7.03%
Total	**-8.45%**	**14.24%**	**5.79%**

27. Table 3 shows that all of the County Council's pooled funds have delivered a positive total return, with the exception of the Schroder Income Maximiser Fund. The Schroder fund invests primarily in UK equities, which have been particularly badly affected by the Coronavirus pandemic. This resulted in a significant reduction in the fund's value during March 2020, albeit there has been a partial rebound since. The Schroder fund has, however, continued to deliver strong income returns to the significant benefit of the County Councils' revenue budget (in excess of 7.5% in 2019/20) and has contributed more income on a percentage basis than any of the County Council's other pooled funds. This is in line with the fund's stated objective of providing income with the potential for capital growth, which it does largely through owning equities that pay dividends and the use of derivatives (short dated call options).

28. In aggregate, the County Council's investments in externally managed pooled funds have achieved the objective of delivering annual income returns of about 4%. These investments have generated in excess of £24m in dividend payments since the first investment was made in 2014 and have produced an annualised income return of 4.57%. This additional investment income has helped to reduce the overall level of savings the County Council has had to find from its service revenue budgets during the various iterations of its transformation programme.

29. Table 4 shows the income generated by the higher yielding strategy since the allocation to these investments was increased to £200m in 2017. For comparison, had the County Council held solely more traditional treasury management investments, only half the income (approximately £18m) could have been achieved over the same 3 year period assuming a yield of 1% on average investment balances.

Table 4 – investment income

Year	Pooled funds	Other higher yielding investments	All other investments	Total
2017/18	£4.6m	£1.2m	£4.7m	£10.5m
2018/19	£6.0m	£1.2m	£5.5m	£12.7m
2019/20	£8.2m	£1.2m	£4.0m	£13.4m
Total	**£18.8m**	**£3.6m**	**£14.2m**	**£36.6m**

30. It is also possible to benchmark the County Council's investment performance against other local authorities. Table 5 shows extracts from Arlingclose's quarterly benchmarking and provides a snapshot as at the end of the 2018/19 and 2019/20 financial years. The returns will vary from quarter to quarter for a variety of macroeconomic and investment specific reasons, but this benchmarking data suggests that the County Council is achieving income returns in excess of the average for other local authorities, and also highlights the significant difference in returns between externally and internally managed funds for the County Council and other local authorities.

Table 5 – Investment returns benchmarked against other Arlingclose clients

As at 31 March 2019	**Hampshire County Council**	**Other similar local authorities**	**All local authorities**
External funds - capital gain/loss	1.14%	0.24%	-0.12%
External funds - income return	4.78%	3.68%	3.78%
Internal funds – income return	1.35%	1.02%	0.85%
All investments - income return	2.37%	1.56%	1.45%
All investments - total return	2.71%	1.61%	1.43%

As at 31 March 2020	**Hampshire County Council**	**Other similar local authorities**	**All local authorities**
External funds - capital gain/loss	-12.35%	-8.82%	-7.62%
External funds - income return	4.54%	4.04%	3.73%
Internal funds – income return	0.97%	0.92%	0.64%
All investments - income return	2.00%	1.55%	1.23%
All investments - total return	-1.56%	-0.39%	-0.34%

Note: for the purposes of this benchmarking data, investments in cash plus funds are shown as external funds however these are not considered long term investments by the County Council and do not form part of the higher yielding strategy.

31. When reviewing the investments held as part of the higher yielding strategy, the County Council monitors whether the portfolio is achieving the stated objectives in aggregate and also how well individual pooled funds are performing. The careful monitoring of this performance is of particular importance to the County Council because it is recognised that the value of these investments will be more volatile than traditional cash instruments and will have a wider range of potential investment outcomes, particularly in the short term.

32. The monitoring of pooled fund investments is conducted both by County Council officers and by Arlingclose. Arlingclose conduct regular meetings with fund managers and carry out ongoing due diligence on behalf of their clients. The County Council's officers review performance data and information provided by the funds and, as the portfolio has now grown to sufficient size, also hold update meetings with representatives of the pooled funds directly in order to provide further scrutiny. To date, officers have met with Kames, CCLA, Schroders and NinetyOne (formerly Investec) during 2020.

33. As long as the County Council does not need to sell its pooled fund investments in the short term, it can wait for capital values to recover from their current position while continuing to receive the benefit of income returns significantly in excess of what could be achieved from cash investments (particularly given Bank Rate was cut to 0.1% in March 2020 and some gilts are trading at negative yields).

34. The County Council must also be mindful of the requirements of the accounting standard IFRS 9, however there is a statutory override in place that means any gains or losses in capital value do not need to be taken as charges to the County Council's revenue account for at least a further 3 financial years.

35. In addition to the usual ongoing due diligence, discussions have been held between Arlingclose and the fund managers about the impact of the global coronavirus pandemic. This has focused not only on fund values but also the ability to continue to provide the targeted investment returns. Arlingclose have provided advice on the potential income impact and the County Council has therefore reduced its interest income forecast for 2020/21. This is in addition to the impact on returns on cash based investments linked to recent reductions in interest rates. A reduction of £3.5m was reported in the paper to Cabinet on the financial impacts of Covid-19 in May 2020.

36. As a result of this ongoing due diligence Arlingclose continue to recommend the funds in which the County Council is invested. Arlingclose’s view remains that capital values can be expected to recover over the County Council’s investment horizon, including for the Schroder Income Maximiser Fund, and that they expect these pooled funds to be positive contributors to the County Council’s treasury management position by delivering income returns in excess of what could be achieved in the current very low interest rate environment.

REQUIRED CORPORATE AND LEGAL INFORMATION:

Links to the Strategic Plan

This proposal does not link to the Strategic Plan but, nevertheless, requires a decision because it relates to the effective management of the County Council's cash balances.

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

<u>Document</u>	<u>Location</u>
None	

EQUALITIES IMPACT ASSESSMENT:

1. Equality Duty

   The County Council has a duty under Section 149 of the Equality Act 2010 ('the Act') to have due regard in the exercise of its functions to the need to:

   - Eliminate discrimination, harassment and victimisation and any other conduct prohibited by or under the Act with regard to the protected characteristics as set out in section 4 of the Act (age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation);
   - Advance equality of opportunity between persons who share a relevant protected characteristic within section 149(7) of the Act (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, sex and sexual orientation) and those who do not share it;
   - Foster good relations between persons who share a relevant protected characteristic within section 149(7) of the Act (see above) and persons who do not share it.

   Due regard in this context involves having due regard in particular to:

   - The need to remove or minimise disadvantages suffered by persons sharing a relevant protected characteristic that are connected to that characteristic;
   - Take steps to meet the needs of persons sharing a relevant protected characteristic that are different from the needs of persons who do not share it;
   - Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity in which participation by such persons is disproportionally low.

2. Equalities Impact Assessment:

Equalities objectives are not expected to be adversely impacted by the proposals in this report.