

**TREASURY MANAGEMENT ANNUAL REPORT 2003/4**  
**(Report by the Head of Financial Services)**

**1. INTRODUCTION**

- 1.1. During 2003/4 the Council had investments averaging £84m. The majority of the investments were managed by Fund Managers with the balance in-house:

| <b>Manager</b>                    | <b>At<br/>1.4.2003</b> | <b>At<br/>31.3.2004</b> |
|-----------------------------------|------------------------|-------------------------|
| Investec Asset Management         | £34m                   | £29m                    |
| Alliance Capital                  | £34m                   | £29m                    |
| City Deposit Cash Managers (CDCM) | £10m                   | £20m                    |
| In-house – average for the year   | £6m                    | £6m                     |

- 2.1 The purpose of this report is to review the performance of the funds during 2003/4, consider if the strategy that the Council has adopted has been effective, address any issues of risk and compliance with statutory and regulatory requirements.

**2. PERFORMANCE OF FUNDS**

- 2.1. The Cabinet has received quarterly reports informing them of the performance of the funds through the year which have led up to the following position:

| <b>PERFORMANCE FOR THE YEAR<br/>APRIL 2003 – MARCH 2004</b> |                          |                        |   |                                   |   |
|---|--------------------------|------------------------|---|-----------------------------------|---|
|   | <b>Performance<br/>%</b> | <b>Benchmark<br/>%</b> | <b>Variation<br/>from<br/>Benchmark<br/>%</b> | <b>Industry<br/>Average<br/>%</b> | <b>Variation<br/>from<br/>Average<br/>%</b> |
| <b>Investec</b>   | <b>2.86</b>              | 3.10                   | <b>-0.24</b>                                  | 3.05                              | <b>-0.19</b>                                |
| <b>Alliance</b>   | <b>3.42</b>              | 3.10                   | <b>+0.32</b>                                  | 3.05                              | <b>+0.37</b>                                |
| <b>CDCM</b>   | <b>4.26</b>              | 3.71                   | <b>+0.55</b>                                  | 3.05                              | <b>+1.21</b>                                |
| <b>In-house</b>   | <b>3.62</b>              | 3.51                   | <b>+0.11</b>                                  | N/A                               | N/A   |

- 2.3 CDCM has performed better than Alliance Capital and Investec both in real terms and compared with their benchmark. Investec produced a disappointing result whereas Alliance Capital's result was satisfactory and above the industry average.

- 2.4 The three Fund Managers continued to have different strategies for choosing the instruments they invest in, and during the year the

mandates for all the Managers were amended slightly. Details of the investment options are shown in the mandates in Annex A.

- 2.5 The Capital Receipts Advisory Group (CRAG), which consists of three Members, has met with the Fund Managers on three occasions during the year. Assisted by officers and Butlers, our investment advisors, they have monitored performance and been able to question the Managers on their strategies.

### **3. INVESTEC**

- 3.1. Investec's performance since the start of the new mandates in July 2000 has been varied. In 2001/2 they produced a poor performance; 2002/3 was an outstanding year, but in the last financial year they have again produced a poor result. It was a difficult year for Fund Managers that invest in CD's and gilts, but Investec added to this difficulties by taking a view about the market in the middle part of the year, that proved to be wrong.

### **4. ALLIANCE CAPITAL**

- 4.1. Alliance Capital also had to contend with difficult trading conditions for CD's and gilts, but its continued investment in a variety of other instruments including corporate bonds and floating rate notes produced better results.

### **5. CDCM**

- 5.1. CDCM can only invest in time deposits, but they have exploited the opportunity to invest part of the portfolio for up to 5 years. The officers, in consultation with the Members of the Capital Receipts Advisory Group, decided to reduce the funds managed by Investec and Alliance Capital by £5m each and give the funds to CDCM. This happened in November 2003 at a time when interest rates for medium term deposits peaked, and CDCM were able to lock in to rates above 5% for 3 to 5 years.

### **6. IN-HOUSE INVESTMENT OF FUNDS**

- 6.1. Any balance of funds is invested 'in-house'. Whereas the external fund managers have a fixed amount to invest, the 'in-house' funds fluctuate on a daily basis due to the volatility of the cash flow to and from the Authority.
- 6.2. The cash position varied from available funds of £12.35m to borrowings of £4.6m, with an average investment of £5.6m.

- 6.3 As these funds are generally needed back within a few weeks there is very limited scope to better the 7 day rate. Nevertheless in 2003/4 it was exceeded by 0.11%.

## 7. STRATEGY

- 7.1. The Council agreed new broader mandates with the three Fund Managers in July 2000. The size of the its reserves meant that the Authority could take the view that the Fund Managers should maximise the returns in the medium term, three years, rather than on an annual basis. Now that the new mandates have been in place for nearly four years, it can be seen that this strategy has been effective.

| <b>CUMULATIVE PERFORMANCE SINCE START OF MANDATES<br/>JULY 2000* – MARCH 2003</b> |                    |                  |   |                             |                                       |
|---|--------------------|------------------|---|-----------------------------|---------------------------------------|
|   | <b>Performance</b> | <b>Benchmark</b> | <b>Variation<br/>from<br/>benchmark</b> | <b>Industry<br/>Average</b> | <b>Variation<br/>from<br/>Average</b> |
|   | <b>%</b>           | <b>%</b>         | <b>%</b>                                | <b>%</b>                    | <b>%</b>                              |
| <b>Investec</b>   | 19.98              | 19.87            | <b>+0.11</b>                            | 18.46                       | <b>+1.52</b>                          |
| <b>Alliance</b>   | 20.13              | 19.31            | <b>+0.82</b>                            | 17.87                       | <b>+2.26</b>                          |
| <b>CDCM</b>   | 20.11              | 17.77            | <b>+2.34</b>                            | 18.46                       | <b>+1.65</b>                          |

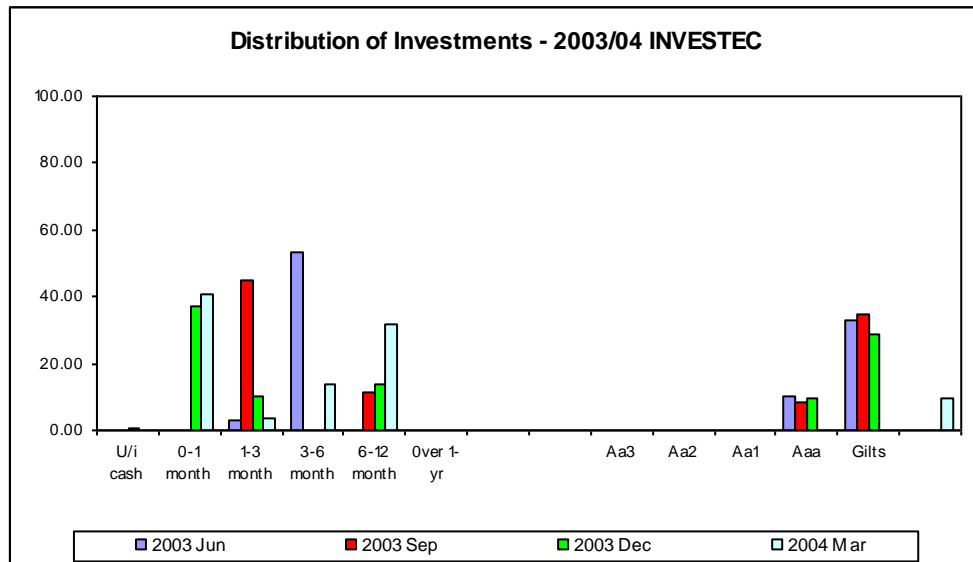
\* The mandate with Alliance Capital started in August 2000

- 7.2. Aggregating the funds under external management the results are:

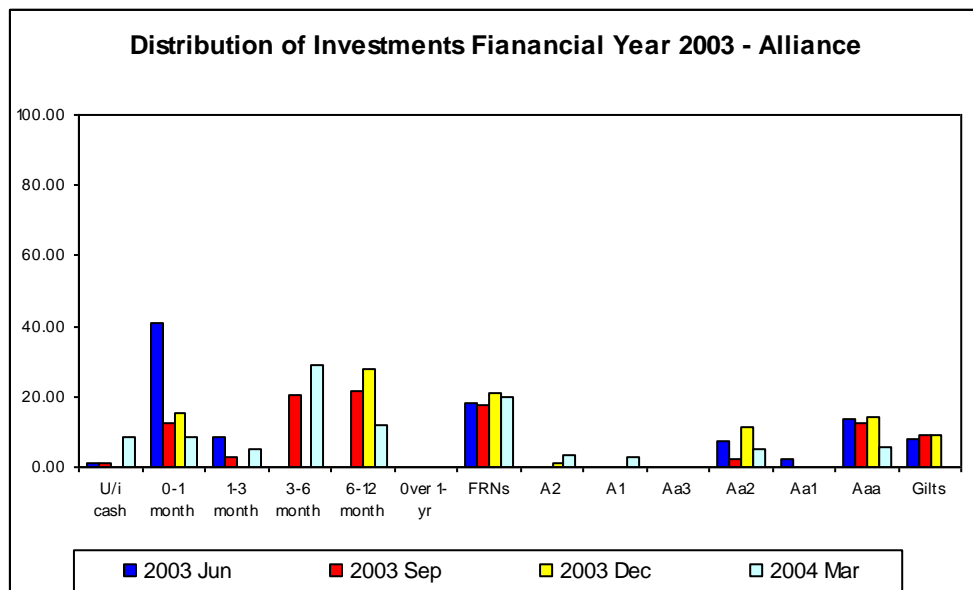
|  | <b>Exceeded<br/>by</b> |
|--|------------------------|
| Benchmark  | 0.71%                  |
| Industry Average   | 1.86%                  |
| 7-day rate (a common local authority benchmark for narrower range investments) | 3.18%                  |

- 7.3. The above table of cumulative returns shows that the performance of Alliance Capital was better than that of Investec; this happened for the first time in 2003/4.

- 7.4. Investec continues to invest mainly in gilts and CD's with a maximum of 10% of the portfolio being in corporate bonds. The graph below shows the distribution of investments at the end of each quarter



7.5. Alliance Capital has from the start of their appointment, had a different strategy to Investec. Their performance has been much steadier, without the peaks and troughs shown by Investec. The mandates for Investec and Alliance Capital also allow them to invest in corporate bonds, floating rate notes (FRN's) and supranationals (bonds that are listed outside London). Alliance Capital has maximised the opportunity to purchase these securities. The graph below shows the types of investments they include in their portfolio; the categories A2 to Aaa are categories of corporate bonds



7.6. CDCM rely completely on term deposits with banks, building societies and other local authorities thus avoiding fluctuations in the value of the investments. They have been proactive in arranging forward deals at attractive rates, and using deals where the rate can be renegotiated every quarter, with the lender (HDC) having the right to take repayment if the new rate is unacceptable.

7.7. Copies of the mandates, as at March 2003, are attached at Annex A. During 2002/03 the following changes were made following requests from the Fund Managers, advice from Butlers and consultation with

the Capital Receipts Advisory Group.

- The maximum limit that could be invested in floating rate notes or corporate bonds with an AA rating or better, be increased from 20% to 40%, but with a maximum of 50% of the fund being held in these combined categories.
- Corporate bonds with a rating of A- be included in the mandate but with a maximum of £1m per issuer.
- £3m investment limit extended to all Building Societies with assets of over £2.5billion.

## **8. RISK IMPLICATIONS**

8.1 The Treasury Management Policy approved by the Cabinet on 27<sup>th</sup> February 2002, emphasises the importance of controlling risk i.e. returns should be maximised but only at an acceptable level of risk.

8.2 There are two main elements of risk. Firstly, that the borrower will be unable to return the loan when it is due and secondly that the Fund Managers will take the wrong view on interest rate movements leading to poor returns. Risk was an important factor taken into account when the mandates were first agreed in 2000. Although the Council allows the Fund Managers to invest in instruments not used by most Councils, the parameters included in the mandates are designed to minimise both types of risks.

8.3 The Authority has minimised these risks in the following ways:

### **Risk of the borrower being unable to repay the investment**

- A significant proportion of the funds are invested in Government "gilts", Certificates of Deposit or Local Authorities. These are all totally safe.
- As far as other investments are concerned, the proportion of which is limited by the mandates, a rigid system of credit rating ensures that only the very safest organisations (those with high credit ratings) are dealt with, together with limits on the value placed with one issuer. The Fund Managers are also highly attuned to any market intelligence that might suggest a borrower is likely to have their credit rating reduced in the future. None of the treasury management transactions during the year have compromised the rules that have been set.

### **Risk of the wrong view on interest rates being taken**

- Three Fund Managers, each with their own strategy for investments, have been engaged. The diversity in their approach minimises the chance of them all taking the wrong view.

- The Authority can still take a longer-term view on investment performance which gives the fund managers the latitude to retain investments where they feel that returns will be made next year rather than this.
- The mandates limit the duration of the investments which reduces the impact on the value if the interest rate view turns out to be incorrect.

### **Seeking Professional Advice**

- Butlers are employed as our Treasury Management Consultants and their advice is sought before any change is made to the mandates.
- They also provide reports on the Fund Managers' performance and compare it with the industry average.

### **Active Monitoring**

- As well as quarterly reports to Cabinet and three meetings per year between Fund Managers and the Capital Receipts Advisory Group your officers monitor returns each month.
- All CDCM investments are actually implemented by your officers who are also asked to confirm all "non-approved" investments before they are made.

## **9. COMPLIANCE WITH REGULATIONS AND CODES**

- 9.1 All the treasury management transactions have been carried out in accordance with the legislation and regulations concerning treasury management.
- 9.2 CIPFA introduced a Code of Practice on Treasury Management in 2002. The Council adopted the Policy Statement in February 2002.
- 9.3 The Code also required that the Council create treasury management practices to assist both Members and Officers in the effective management and control of treasury management activities. These were adopted in 2003/4.
- 9.4 In 2003/4 CIPFA introduced the Prudential Code for Capital Finance and the ODPM brought out new guidance on Local Government investments. Both of these became effective from 1 April 2004, but also required actions to be taken before 31 March 2004.
- 9.5 The Authority met the requirements by Council approving the Prudential Indicators at its meeting on 18<sup>th</sup> February 2004, and the Cabinet approving an Annual Investment Strategy on 25<sup>th</sup> March 2004.

## **10. CONCLUSION**

- 10.1 The wider mandate given to Investec and Alliance Capital has given them some freedom to invest in securities other than gilts and certificates of deposit. Alliance Capital gave a satisfactory performance in 2003/4 that was better than their benchmark and the industry average. Investec's performance was disappointing, in direct contrast to their results in 2002/3. CDCM produced the best returns by investing in the medium term when interest rates peaked.
- 10.2 Due to the nature of the Authority's strategy performance should not be judged on the basis of a single year. The results from the start of the new broader mandates show that the Authority has adopted a sound strategy and selected Fund Managers that have exceeded their benchmarks and the industry average over the four years, The size of the funds with each Manager was varied during the year to reflect the excellent performance of CDCM, the under-performance of Investec and the need to gradually move to a shorter term strategy as reserves are reduced.
- 10.3 The Authority has carried out its treasury management activities with due regard to minimising risk, and in accordance with legislation. It has adopted the CIPFA Code on Treasury Management, the Prudential Code for Capital Finance and the ODPM's guidance on Local Government investments.

## **11. RECOMMENDATION**

- 11.1 It is recommended that the content of this report be note

## **BACKGROUND INFORMATION**

2003/4 cash management files and working papers

Quarterly reports to the Cabinet

## **CONTACT OFFICER**

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## EXTERNAL FUND MANAGER MANDATES

**Alliance Capital and Investec**

|                         |   |
|-------------------------|---|
| Duration of investments | Average duration of Fund must not exceed 3 years<br>No individual investment shall exceed 10 years  |
| Types of investments    | Marketable securities issued or guaranteed by the UK Government ( <b>Gilts</b> )<br>Deposits made with or marketable certificates of deposit issued by approved banks ( <b>CDs</b> )<br>Sovereign and supranational securities, including floating rate notes ( <b>Bonds</b> )<br>Corporate, bank and building society securities, including floating rate notes, commercial paper and asset backed securities ( <b>Corporate Bonds</b> ) |
| Credit Ratings          | <b>CORPORATE INVESTMENTS</b><br><br>Standard & Poors AA or above or equivalent<br><br>Standard & Poors A- or above or equivalent with a maximum £1m per issuer and a total of 10% of the portfolio<br><br><b>SHORT-TERM INVESTMENTS</b><br><br>Standard & Poor's AP/P1 or above or equivalent   |
| Maximum limits          | 20% Supranational and sovereign securities<br>40% Corporate Bonds ) maximum 50%<br>40% Floating rate notes ) combined<br>75% Gilts<br>75% Corporate Bonds plus Gilts<br>50% Corporate bonds + supranational and sovereign securities + floating rate notes<br>20% with any one counterparty (except UK Government and corporate bonds rated A-)   |
| Benchmark               | 60% 3 month LIBID<br>40% 0-5 year gilt index.   |

**CDCM**

|                         |   |
|-------------------------|---|
| Duration of investments | Up to and including 5 years maximum maturity<br>No more than 50% may be invested for longer than 3 years  |
| Types of investments    | Fixed Deposits<br>Deposits at call, two or seven day notice   |
| Credit Ratings          | F1+ by FITCH IBCA or equivalent   |
| Maximum limits          | £3m per institution and group for English and Scottish Clearing Banks and their subsidiaries, and Overseas Banks on list of authorised counterparties.<br>Building Societies<br>With assets above £2.5billion £3m<br>Other Societies in the top 20 by assets £2m<br>21 – 25 £1m |
| Benchmark               | 3 month LIBID   |