CABINET **9th JUNE 2005**

TREASURY MANAGEMENT ANNUAL REPORT 2004/5
(Report by the Head of Financial Services)

1. INTRODUCTION

1.1. During 200/54 the Council had investments averaging £81m. The majority of the investments were managed by Fund Managers with the balance in-house:

Manager	**At 1.4.2004**	**At 31.3.2005**
Investec Asset Management	£29m	£26.5m
Alliance Capital	£29m	£26.5m
City Deposit Cash Managers (CDCM)	£20m	£20m
In-house – average for the year	£6m	£1m

2.1 The purpose of this report is to review the performance of the funds during 2004/5, 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:

	PERFORMANCE FOR THE YEAR APRIL 2004 – MARCH 2005				
	Performance %	**Benchmark %**	**Variation from Benchmark %**	**Industry Average %**	**Variation from Average %**
Investec	**4.82**	4.55	**+0.27**	4.68	**+0.14**
Alliance	**4.68**	4.55	**+0.13**	4.68	**0.00**
CDCM	**4.99**	4.59	**+0.40**	4.68	**+0.31**
In-house	**4.73**	4.57	**+0.16**	N/A	N/A

2.3 For the second year running, CDCM has performed better than Alliance Capital and Investec both in real terms and compared with their benchmark, although only marginally. For the year as a whole the rising trend in interest rates created an environment in which it was possible to maintain a cautious investment approach yet exceed the benchmark return. The managers did that and produced satisfactory returns, however the market gave little opportunity for the Fund Managers to add value

2.4 The Capital Receipts Advisory Group (CRAG), which consists of three Members, has met with the Fund Managers on two 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, 2003/4 was another poor year but last year they produced satisfactory returns, beating their benchmark and the industry average.

4. ALLIANCE CAPITAL

4.1. Alliance Capital continued to invest in corporate bonds and floating rate notes, which contrasts with the strategy of Investec, which mostly deals in gilts and certificates of deposit. Alliance Capital had a passive approach to their activity in the market in the second half of the year, as they had correctly positioned the investments earlier in the year.

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. In 2004/5 their return benefited from longer-term investments made in 2003/4 at rates over 5%.

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 £10.55m to borrowings of £6.5m, with an average investment of £1m. The strategy was for the majority of the funds to be with the Fund Managers, hence the average in-house investments were close to zero. In March 2005 we requested a return of £2.5m from Investec and from Alliance Capital to meet the Council's cash flow requirements.

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 2004/5 it was exceeded by 0.16%.

7. STRATEGY

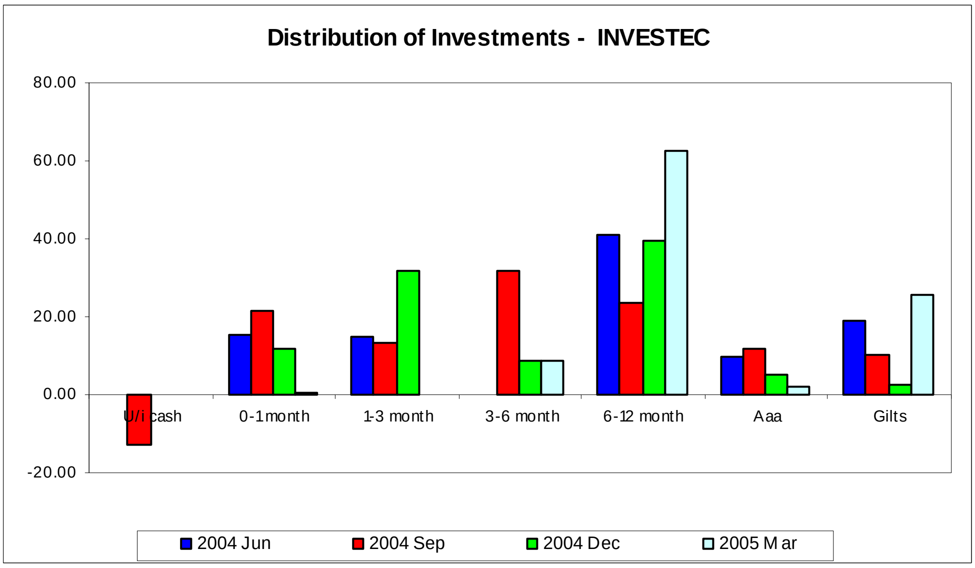
7.1. The Council agreed new broader mandates with the three Fund Managers in July 2000. The size of the its reserves meant that the Authority could take the view that the Fund Managers should maximise the returns in the medium term, three years, rather than on an annual basis. Now that the new mandates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

	CUMULATIVE PERFORMANCE SINCE START OF MANDATES JULY 2000* – MARCH 2005				
	Performance %	**Benchmark %**	**Variation from benchmark %**	**Industry Average %**	**Variation from Average %**
Investec	25.76	25.33	**+0.43**	24.01	**+1.75**
Alliance	25.75	24.74	**+1.01**	23.38	**+2.37**
CDCM	26.10	23.18	**+2.92**	24.01	**+2.09**

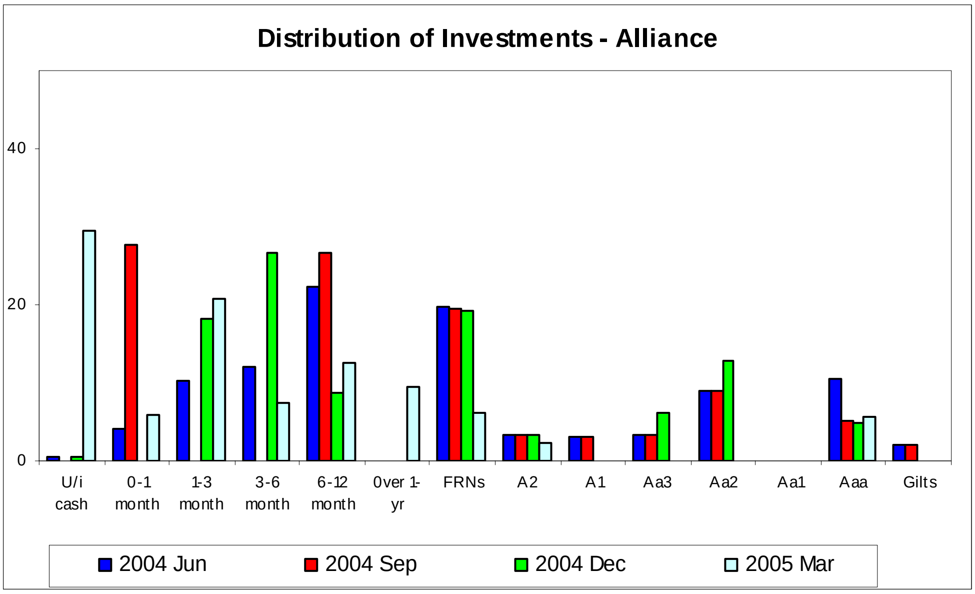
* The mandate with Alliance Capital started in August 2000

7.2. The above table of cumulative returns shows that the performance of Alliance Capital and Investec were almost identical after 4 ¾ years of the current mandates.

7.3. 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



7.4. 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



7.5. 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.

7.6. Copies of the mandates, as at March 2005, are attached at Annex A. During 2004/5 the following changes were made following requests from the Fund Managers, advice from Butlers and consultation with the Capital Receipts Advisory Group.

- £5m investment limit (previously £3m) extended to all Building Societies with assets of over £2billion

- £3m investment limit (previously £2m) extended to all Building Societies with assets of over £1billion

- £2m investment limit (previously £1m) extended to all other Building Societies in the top 25 by asset value

8. RISK IMPLICATIONS

8.1 The Treasury Management Policy approved by the Cabinet on 27th 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 three main elements of risk. Firstly, that the borrower will be unable to return the loan when it is due, secondly that the Fund Managers will take the wrong view on interest rate movements leading to poor returns, thirdly that the investments are not sufficiently liquid to be able to be sold to meet the cash flow needs of the Authority. 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 all 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.

Risk of the funds not being available to be returned to the Council

- Investec and Alliance invest in instruments that are all liquid. The mandate for CDCM allows it to invest a maximum of 25% of the fund, (currently £5m) for longer than 3 years. As the total funds invested are reduced, the duration of the investments allowed in the mandate, will need to be amended and your officers monitor this regularly

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.

- During the year the treasury management consultancy service was subject to tender. Butlers were re-appointed from 1 January 2005 for 2 years with an option to extend the appointment for a further year.

Active Monitoring

- As well as quarterly reports to Cabinet and meetings 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-specified" investments in corporate bonds by Alliance Capital and Investec 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.

9.5 The Authority met the requirements by Council approving the Prudential Indicators and the Treasury Management Strategy at its meeting on 16th February 2005.

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 and Investec gave satisfactory performances in 2004/5 that were better than their benchmark and better than or equal to the industry average. CDCM produced the best returns by benefiting from longer-term investments made in 2003/4 with rates over 5%.

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 five years.

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 noted

BACKGROUND INFORMATION

2004/5 cash management files and working papers

Quarterly reports to the Cabinet

CONTACT OFFICER

Mrs Eleanor Smith Financial Resources Manager Tel. 01480 388157

ANNEX A

EXTERNAL FUND MANAGER MANDATES

Alliance Capital and Investec

Duration of investments	Average duration of Fund must not exceed 3 years No individual investment shall exceed 10 years
Types of investments	Marketable securities issued or guaranteed by the UK Government **(Gilts)** Deposits made with or marketable certificates of deposit issued by approved banks **(CDs)** Sovereign and supranational securities, including floating rate notes **(Bonds)** Corporate, bank and building society securities, including floating rate notes, commercial paper and asset backed securities **(Corporate Bonds)**
Credit Ratings	**CORPORATE INVESTMENTS** Standard & Poors AA- or Aa3 or above or equivalent A- or A3 or better, maximum term 3 years **NON-UK GOVERNMENTS AND SUPRANATIONALS** AA- or Aa3 or above or equivalent for non-UK Governments AAA or Aaa for Supranationals **SHORT-TERM INVESTMENTS** Standard & Poor's A1/P1 or above or equivalent
Maximum limits	40% Corporate Bonds 20% Supranational and sovereign securities 40% Floating rate notes 75% Gilts 75% Corporate Bonds plus Gilts 50% Corporate bonds + supranational and sovereign securities + floating rate notes 20% with any one counterparty (except UK Government) for fixed deposits and CDs 10% per issuer or £1m for corporate bonds and FRNs 10% per issuer for securities guaranteed by non-UK EU Governments and supranational securities
Benchmark	60% 3 month LIBID 40% 0-5 year gilt index.

CDCM

Duration of investments	Up to and including 5 years maximum maturity No more than 25% may be invested for longer than 3 years
Types of investments	Fixed Deposits 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. Building Societies With assets more than £2,000m £5m With assets more than £1,000m £3m Other building societies in the top 25 £2m
Benchmark	3 month LIBID