CABINET **7th JUNE 2007**

TREASURY MANAGEMENT ANNUAL REPORT 2006/07
(Report by the Head of Financial Services)

1. INTRODUCTION

1.1. During 2006/07 the Council continued to have significant investments. The majority was managed by Fund Managers with the balance in-house as shown below:

Manager	Start of the year £m	End of the year £m
Investec Asset Management	21.5	£21.5
Alliance Bernstein	21.5	nil
City Deposit Cash Managers (CDCM)	20.0	£31.5
In-house	-11.1**	nil

** net temporary borrowing

1.2 This report reviews the performance during 2006/07, considers if the strategy that the Council has adopted has been effective, and addresses any issues of risk and compliance with statutory and regulatory requirements. It also explains the reasons for reducing the number of fund managers from three to two and the preparations taken to borrow in advance should the right market conditions prevail.

2. PERFORMANCE OF FUNDS

2.1. For the fourth year running, CDCM has performed better than Alliance Bernstein and Investec. Alliance Bernstein provided satisfactory returns when measured against the benchmark and industry average but Investec have performed poorly. The report on the performance for the final quarter January to March 2007 is shown at Annex A. The performance for the year is given below:

PERFORMANCE FOR THE PERIOD APRIL 2006 – MARCH 2007					
	Performance %	Benchmark %	Variation from benchmark	Industry average %	Variation from average %
Investec	**3.98**	4.06	**-0.08**	4.29	**-0.31**
Alliance	**4.44**	4.06	**+0.38**	4.29	**+0.16**
CDCM	**5.10**	5.03	**+0.07**	4.29	**+0.81**

2.3 The Capital Receipts Advisory Group (CRAG), which consists of three Members, has been kept informed of relevant issues throughout the year and met with Fund Managers in November 2006 to discuss performance and future strategies.

3. INVESTEC

3.1. Investec's performance since the start of the new mandates in July 2000 has been varied. In 2001/02 they produced a poor performance; 2002/03 was an outstanding year, 2003/04 was another poor year, in 2004/05 they produced satisfactory returns. In both 2005/06 and 2006/07 they did not achieve the benchmark or the industry average.

4. ALLIANCE BERNSTEIN

4.1. Alliance Bernstein continued to invest in corporate bonds and floating rate notes, in contrast with Investec, which mostly deals in gilts and certificates of deposit. Alliance Bernstein has been more consistent in their returns over the seven years without having the peaks and troughs of Investec.

5. CDCM

5.1. CDCM only invest in time deposits but have exploited the opportunity to invest part of the portfolio for up to 3 years at rates over 5%. They recognised that these rates were based on market expectations that base rates would rise but considered that the overall return over the whole period of the investment would still be attractive. The success of this approach will only become clear at the end of each investment. In the meantime it has enhanced the performance of the fund.

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 net investments of £12.6m to net borrowings of £11.1m. This borrowing complied with the strategy of stabilising the funds with the Managers as long as possible.

6.3 As any investments are generally needed back within a few weeks there is very limited scope to better the 7 day rate. Nevertheless in 2006/07 it was marginally exceeded by 0.07%.

7. STRATEGY

7.1. The Council agreed new broader mandates with the three Fund Managers in July 2000. The size of 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 seven years, it can be seen that this strategy has been effective.

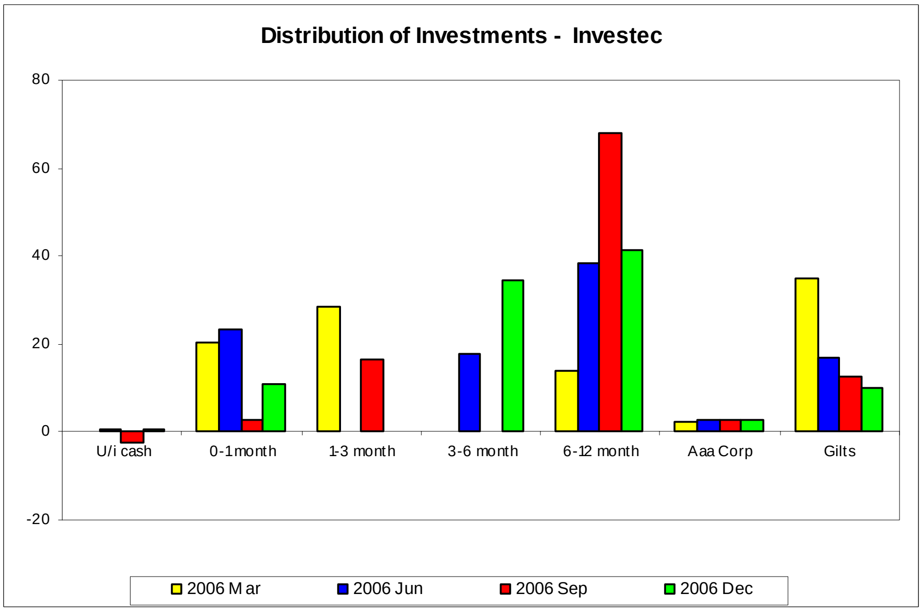
7.2. The usual benchmark for Local Authority investment funds is the 7-day rate. We selected a 3 month cash deposit rate for CDCM and a combination of 3 month cash and 0-5year gilts for Investec and Alliance Capital, as their benchmarks. All 3 funds have exceeded the cumulative 7-day rate of 34.4%.

	CUMULATIVE PERFORMANCE SINCE START OF MANDATES JULY 2000* – MARCH 2006				
	Performance %	**Benchmark %**	**Variation from benchmark %**	**Industry Average %**	**Variation from Average %**
Investec	37.0	36.6	**+0.4**	35.3	**+1.7**
Alliance	37.7	36.0	**+1.7**	34.6	**+3.1**
CDCM	39.2	35.3	**+3.9**	35.3	**+3.9**

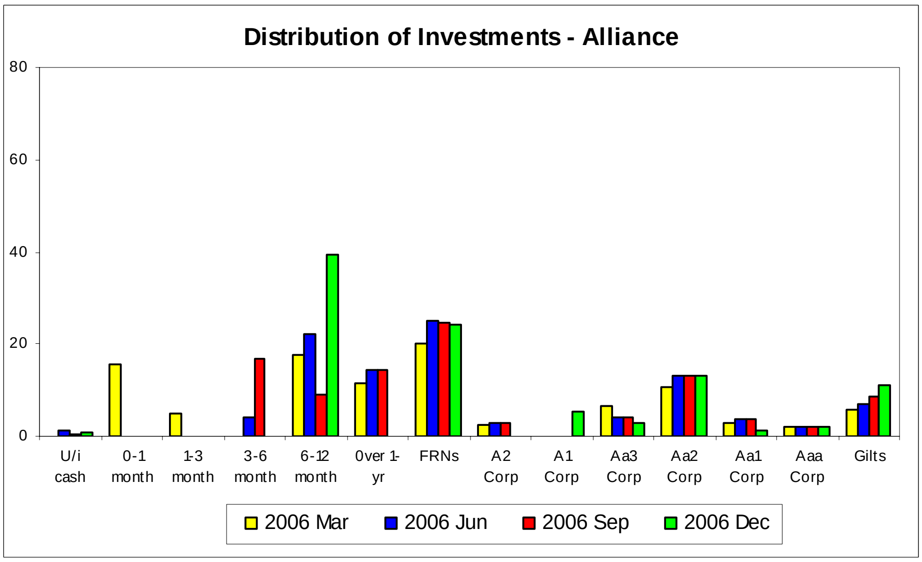
* The mandate with Alliance Capital started in August 2000
Returns are not compounded.

7.3. The above table of cumulative returns shows that the performance of Alliance Bernstein and Investec was quite close after nearly 7 years.

7.4. Investec continues to invest mainly in gilts and CD's with a maximum of 3% of the portfolio being in corporate bonds. The graph below shows the distribution of investments at the end of each quarter. This graph and that for Alliance are for the year to 31 December 2006; this is because we had no investments with Alliance as at 31 March 2007 to compare with Investec at the year-end.



7.5. Alliance Bernstein has from the start of their appointment, had a different strategy to Investec. The mandates for Investec and Alliance Bernstein also allow them to invest in corporate bonds, floating rate notes (FRNs) and supra-nationals (bonds that are listed outside London). Alliance Bernstein 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 2007, are attached at Annex B. No changes were made during the year to the mandates.

8. WITHDRAWAL OF FUNDS FROM ALLIANCE BERNSTEIN

8.1 Spending forecasts showed that sums would need to start to be withdrawn from fund managers during March and April 2007 and as a result of Alliance Bernstein wishing to withdraw from the local authority market it was decided by CRAG that these sums would be withdrawn in stages from their fund. Once they were given notice of this they requested that the process be speeded up and the entire £21.5m portfolio was returned during February and March 2007. Those sums not immediately required were added to CDCM's fund.

9. BORROWING IN ADVANCE

9.1 The 2006/07 MTP showed that from 2008/09 the Council would need to borrow to finance capital expenditure. Following discussion with external auditors, it was agreed, and included within the Treasury Management Strategy, that the Council would borrow in advance a maximum of the forecast borrowing during the MTP period as long as it was considered that the rates were attractively low, compared with future expectations of long term rates.

9.2 Advice was taken as to a target low level for this borrowing. However since the point where the new HQ project (the main element of the need to borrow) became committed rates have not fallen to that level. The position is monitored on a daily basis but it is not expected that there will be another opportunity until base rates begin to fall again.

10. RISK IMPLICATIONS

10.1 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.

10.2 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.

10.3 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 at any given time.

- 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. The 2007/08 Treasury Management Strategy changes with a requirement that 50% must be repayable within 12 months to reflect the fact that most of the funds will need to be returned over the coming years.

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 meetings between Fund Managers and the Capital Receipts Advisory Group, your officers monitor returns each month.

11. COMPLIANCE WITH REGULATIONS AND CODES

11.1 All the treasury management transactions have been carried out in accordance with the legislation and regulations concerning treasury management.

11.2 The Council met the requirements of the CIPFA Code of Practice on Treasury Management by adopting a Policy Statement in February 2002 and Treasury Management Practices in 2003/04. These assist both Members and Officers in the effective management and control of treasury management activities.

11.3 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. These require the Council to approve Prudential Indicators and an annual Treasury Management Strategy. Those for 2007/08 were approved at the Council meeting on 21st February 2007. Annex C shows the relevant indicators and the actual results that were all within the limits set.

12. CONCLUSION

12.1 Alliance Bernstein gave a satisfactory performance in 2006/07 that was better than their benchmark and the industry average. Investec's performance was disappointing. CDCM produced the best returns partly from longer-term investments made in 2003/04 with rates at over 5%.

12.2 Alliance Bernstein funds were withdrawn in February and March 2007, some of which were placed with CDCM.

12.2 Due to the nature of the Authority's strategy, performance cannot 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 seven years.

12.3 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.

13. RECOMMENDATION

13.1 It is recommended that the content of this report be noted

BACKGROUND INFORMATION

2006/07 cash management files and working papers

Quarterly reports to the Cabinet

CONTACT OFFICER

Mrs Eleanor Smith Accountancy Manager Tel. 01480 388157

Annex A

TREASURY MANAGEMENT
INVESTMENT PERFORMANCE
JANUARY TO MARCH 2007

1 INTRODUCTION

1.1 This report comments on the performance of the fund from January to March 2007.

2. CHANGE IN FUND MANAGERS

2.1 The Treasury Management Strategy, approved by Cabinet on 1 February 2007, highlighted the intention of withdrawing our funds from Alliance Bernstein.

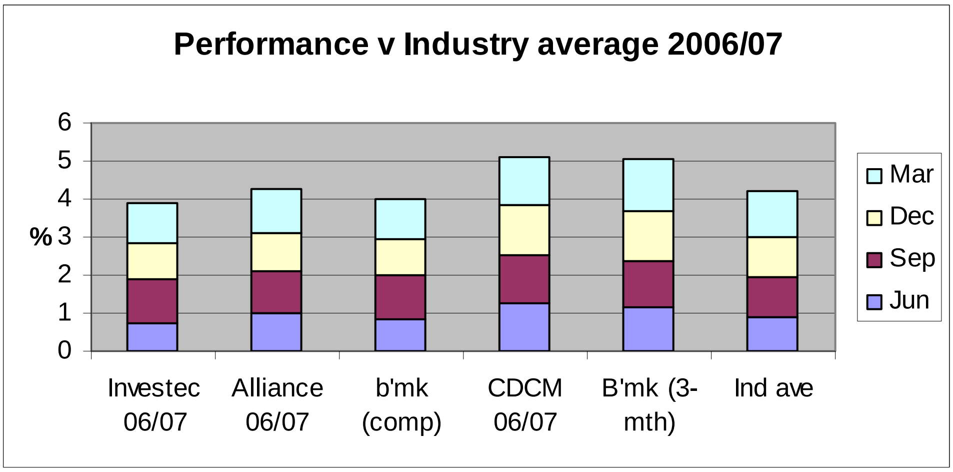
2.2 Although the plan was to withdraw funds in stages, Alliance Bernstein requested that all the funds be returned by 19 March 2007. Of their portfolio of £21.5m, £10m was needed to meet the end-of-year cash flow requirements and the remaining £11.5m was placed with CDCM to manage. This was done so that the Authority could benefit from marginally higher rates from CDCM compared with in-house investment.

3. PERFORMANCE SUMMARY

3.1 **January to March 2007**
The comparative performances are given in the table below and shown graphically overleaf.

3.2 The performance of CDCM was satisfactory in actual terms with a return of 1.28% but this was below the benchmark and the 7 day rate. It falls short of earlier successes but is better than the return of Investec. Investec, on the other hand was faced with ongoing difficulties in the market. The usual rally in gilt prices in January did not materialise and the value of CDs fell during the quarter. As a result the actual return was just 1.08%; better than the benchmark but below the 7 day rate and the industry average.

PERFORMANCE FOR THE QUARTER JANUARY – MARCH 2007					
	Performance %	Benchmark %	Variation from benchmark	Industry average %	Variation from average %
Investec	**1.08**	1.06	**+0.02**	1.21	**-0.13**
Alliance	**1.14**	1.06	**+0.08**	1.21	**-0.07**
CDCM	**1.28**	1.37	**-0.09**	1.21	**+0.07**



4. PERFORMANCE AGAINST BUDGET IN 2006/07

4.1 The investment interest for the year was £2,924k compared with an original budget of £2,785k giving additional interest of £139k.

5. OUTLOOK

5.1 CDCM has outperformed Investec and Alliance Bernstein for four consecutive years. Their performance will fall, in relative terms, during 2007/08 as their recent strategy has been based on investments at very advantageous rates when they were taken out but with the knowledge that they would become less advantageous when base rates rose. Rates have clearly risen and the correctness of their strategy over the life of the investments will depend on how base rates move in coming months.

5.2 The market view is that economic and market conditions will improve in 2007/08 to the benefit of fund managers such as Investec. However this does depend on them gauging the timing correctly and so the Capital Receipts Advisory Group will be discussing whether to mitigate this risk by taking these investments back and investing them as cash deposits at market rates, either through CDCM or in-house .

ANNEX B

EXTERNAL FUND MANAGER MANDATES

Alliance Bernstein 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	50% Corporate Bonds 20% Supranational and sovereign securities 50% 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

Annex C

Prudential Indicators for 2006/07 relating to Treasury Management
Comparison of actual results with limits

The authorised limit for external debt.
This is the maximum limit for borrowing and is based on a worst-case scenario.

2006/7 Limit £000	**2006/7 Actual £000**
35,000	**14,500**

The operational boundary for external debt.
This reflects a less extreme position. Although the figure can be exceeded without further approval it represents an early warning monitoring device to ensure that the authorised limit (above) is not exceeded.

2006/7 Limit £000	**2006/7 Actual £000**
15,000	**14,500**

Adoption of the CIPFA Code
The Prudential Code requires the Authority to have adopted the CIPFA Code of Practice for Treasury Management in the Public Services.
This has been adopted.

Exposure to investments with fixed interest and variable interest.
These limits are given as a percentage of total investments.

	2006/7 Limit
Upper limit on fixed rate exposure	100%
Upper limit on variable rate exposure	84%

The limit is based on the mandates for the Fund Managers. As they did not breach the mandates, this prudential indicator has been within the limits

Borrowing Repayment Profile

The proportion of 2006/7 borrowing that will mature in successive periods.

	Upper limit	**Actual**	Lower limit	**Actual**
Under 12 months	100%	**100%**	100%	**100%**
12 months and within 24 months	0%	**0%**	0%	**0%**
24 months and within 5 years	0%	**0%**	0%	**0%**
5 years and within 10 years	0%	**0%**	0%	**0%**
10 years and above	0%	**0%**	0%	**0%**

In 2006/07 all the borrowing was temporary for cash flow purposes

Investment Repayment Profile

Limit on the value of investments that cannot be redeemed within 364 days.

2006/7 Limit £000	**2006/7 actual £000**
30,800	**25,500**

The only investments that meet this criterion are time deposits managed by CDCM that are invested to a fixed maturity date for a year or longer.