Report for information

Report to	Executive 17 September 2008	8
Report of	Head of Finance	
Subject	Treasury Management – Investment Performance 2007/08	

Purpose

To advise members of the Council's Treasury Management Investment Performance for 2007/08.

Recommendations

Report is for information

Financial Consequences

None directly from the report.

Risk Assessment

Strategic Priority and Outcome/Service Priorities

The report highlights the contribution the Council's Treasury Management Team makes both to the Council's resources and stewardship.

Executive Member: Councillor Waters - Corporate Resources and Governance

Ward: All wards

Contact Officers

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Background Documents

Annex A

Report

Background

1. The Council's Treasury Management Strategy requires that member receive a report on Investment Performance by 30th September 2008.

Detail

2. The Council's investment performance is monitored by our appointed external investment advisors Butlers. A review of the Council's performance is attached in Annex A to this report

   The key messages to note are;

   - The Council rate of return on investments was 5.9% compared with 4.9% for 2006/07 and the 2007/08 benchmark of 5.6% (7day rate).
   - The Council achieved £3.1 million investment income in 2007/08, which compares £2.0 million for 2006/07.
   - The Council's investment performance should continue to exceed the benchmark during 2008/09

Annex A

Norwich City Council

Investment Review 2007-08 and 1st Quarter 2008-09

Introduction

This report looks at the internal investment performance of the Council in 2007-08 and the first quarter of 2008-09. Investment details have been provided by Council officers where possible and the comparisons of performance will be made against various money market rates.

The difficulty with analysing and assessing Council investment performance is that local circumstances will play a fundamental part in deciding which investments are made. The main driver behind investment decisions will be the nature of the funds, ie are they cash flow or cash fund money. Cash flow money will likely provide little scope for active investment of funds and as such a performance significantly ahead of particular benchmarks will be difficult to achieve. However, if the Council has identified that a proportion of their outstanding investments has a longer outlook then this will help the Council to outperform short term cash benchmarks.

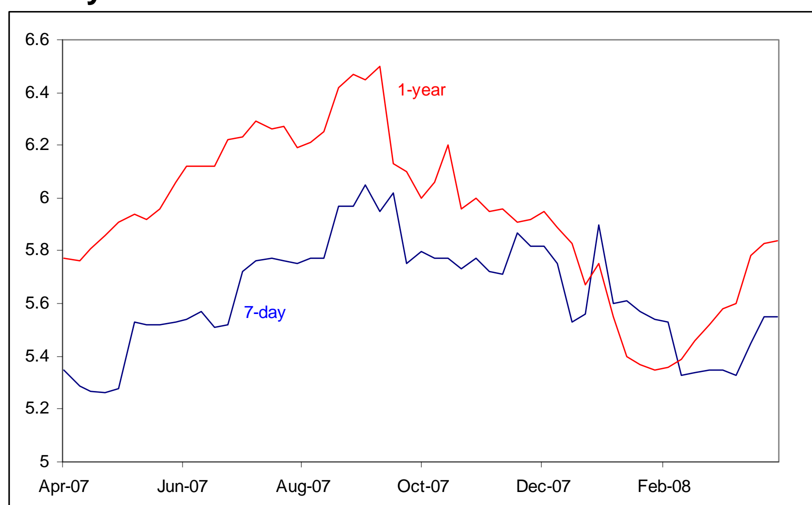
Adding to these factors is the economic background. The period under review has been unprecedented in terms of market activity. More than in any other year, the type of investments made have had a fundamental impact on performance.

Economic Background

The rising trend in UK interest rates continued in the first half of the 2007/08 financial year, although conditions in the money market were severely disturbed by the summer months when the problems associated with US sub-prime mortgage loans spiralled out of control.

The domestic economic backdrop continued to present problems for the Monetary Policy Committee, notably in the early summer. CPI inflation breached the 3% upper limit of the Government's target range in April (reported in May), consumer spending growth remained buoyant and an expanding number of companies expressed intentions to raise prices.

Money Market Rates



Official Bank Rate was raised to 5.5% in May and 5.75% in July in response to the deteriorating inflation outlook. In addition, the Bank of England's May and August Inflation Reports hinted that more hikes might be necessary if the Government's target was to be met over the medium term. Money market pessimism worsened as a result.

The market was plunged into chaos in late August as the tightening of credit conditions, triggered initially by the failure of a selection of US mortgage lending institutions, undermined investor confidence. Rates rose to well over 6.5% as financial organisations' reluctance to lend money to counterparties sparked a severe shortage of funds in the market. In the UK, the crisis came to a head with the failure of the Northern Rock Bank (September) and while the danger of potential meltdown was defused by the Government's decision to guarantee all deposits with this institution, this failed to prevent a prolonged tightening of credit conditions.

Banks and other financial organisations remained reluctant to lend to each other, a situation that ensured a severe shortage of liquidity. Central banks strove to boost market liquidity via the injection of funds to the banking system and there were signs that this might be working in January. But a series of disappointing financial results and a persistent undercurrent of mistrust ensured a wide margin between official and market rates continued to year end.

The credit crisis provoked a significant change in the Bank of England's assessment of UK economic prospects over the medium term. It was clearly concerned that the tightening of liquidity and the consequent rise in borrowing rates across the entire economy could lead to a rapid slowdown in activity. This would help to contain inflation pressures. Bank Rate was cut by 0.25% on two occasions, December and February, to end the year at 5.25%.

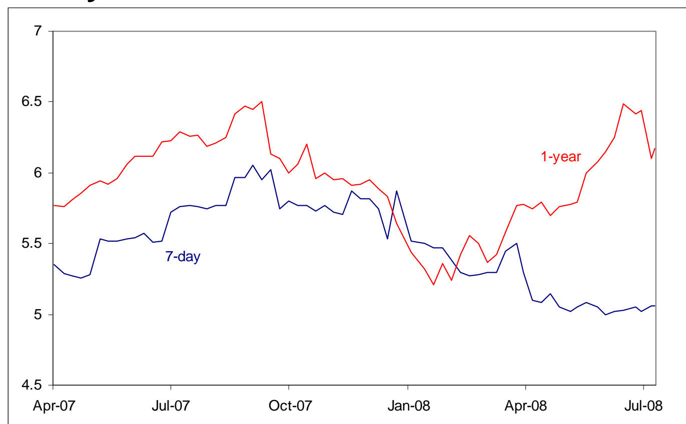
The final vestiges of optimism about the overall outlook for interest rates evaporated in the first quarter of the new financial year. This came in the face of mounting inflation pressures and concerns that key economies, notably the US, might experience a damaging phase of stagflation.

Views on domestic interest rate prospects were more-or-less evenly divided as the quarter got under way. Activity was beginning to slow down and the Bank of England's suggestion that any pick up in CPI inflation would prove temporary seemed reasonably credible to the majority of market participants. Further cuts in official interest rates in the UK and US (Bank Rate was cut to 5% on 10 April and the US Federal Funds rate was cut to 2% on 30 April) kept the optimistic tone alive for a while.

In spite of this modest optimism, money market rates failed to respond. Very short-term rates did fall in the wake of the cut in official interest rates but longer maturities remained unaltered, a situation that underlined very clearly the persistence of very tight credit conditions. The deep suspicion between financial institutions, spawned by the 2007 "credit crunch", remained firmly in evidence as there were few signs that the crisis faced by many banks was past its peak.

Attempts by the Bank of England to ease the log-jam in the markets by introducing a Special Liquidity Scheme in which financial organisations could swap high quality asset-backed securities for Treasury bills which could be used as collateral for raising cash, while taken up enthusiastically, had little tangible effect on market rates.

Money Market Rates



Sentiment in the market deteriorated steadily as the quarter progressed. Worse than expected inflation data and disturbing signs that the personal sector's inflation expectations were beginning to deteriorate led officials to warn that measures to combat price pressures might prove necessary, especially if a damaging round of generous pay settlements were to materialise. Other central banks expressed similar sentiments (the ECB actually hiked rates by a quarter point to 4.25% at its June policy meeting) and these all combined to trigger a decisive swing to more pessimistic territory.

Longer-dated deposit rates were worst affected and a steep rise beyond the 6-month area, while of great benefit for those looking to make fresh fixed term loans, undermined the market value of negotiable instruments, notably certificates of deposit.

The wave of pessimism reached its peak towards the closing days of June. A flurry of weaker than anticipated activity statistics did persuade the markets that the risks of any marked tightening of domestic monetary policy in the closing stages of 2008 was unlikely. But a continued undercurrent of uncertainty over the UK's inflation prospects served as a significant block on any decline in rates from their peak levels.

Investment Activity

As in previous years, the Council has focussed much of its investment in short-dated maturities. There were 533 investments made during 2007-08 and of these 74% were made with either the Co-op or Debt Management Office with an average maturity of just 1 day. The first quarter of the latest year contained 140 investments (including those still active from the previous year) of which 64% were made with either the Co-op or DMO. Again the average for these investments was 1 day.

Year	2006-07	2007-08	to June 08
Total number of investments	622	533	140
Total number with Co-op / DMO	405 (65.1%)	395 (74.1%)	90 (64.3%)
Overall average size	£2.06m	£2.2m	£2.0m
Co-op (Non-PSRA) / DMO average size	£4.6m	£4.3m	£3.9m
Overall return	4.892%	5.934%	5.869%
Co-op (Non-PSRA) / DMO return	4.827%	5.552%	5.015%
Overall average investment length	25 days	34 days	35 days
Co-op (Non-PSRA) / DMO average investment length	1 day	1 day	1 day

As outlined above, the economic and market background had a fundamental impact on performance. Average investment length was 34 and 35 days respectively for the two periods. These averages coincided with the widest dislocation between street and official interest rates and as such had a beneficial impact on performance. For 2007-08 outperformance of the 7 day rate was around 33bps, while in the first quarter of 2008-09 this rose sharply to 88bps. The main reason behind the sharp change in outperformance is not in terms of the investments made, but in terms of the benchmark performance. In 2007-08 it was 5.607% while in the first quarter of 2008-09 it dropped to just 5.055% as liquidity at the very short end of the market picked up.

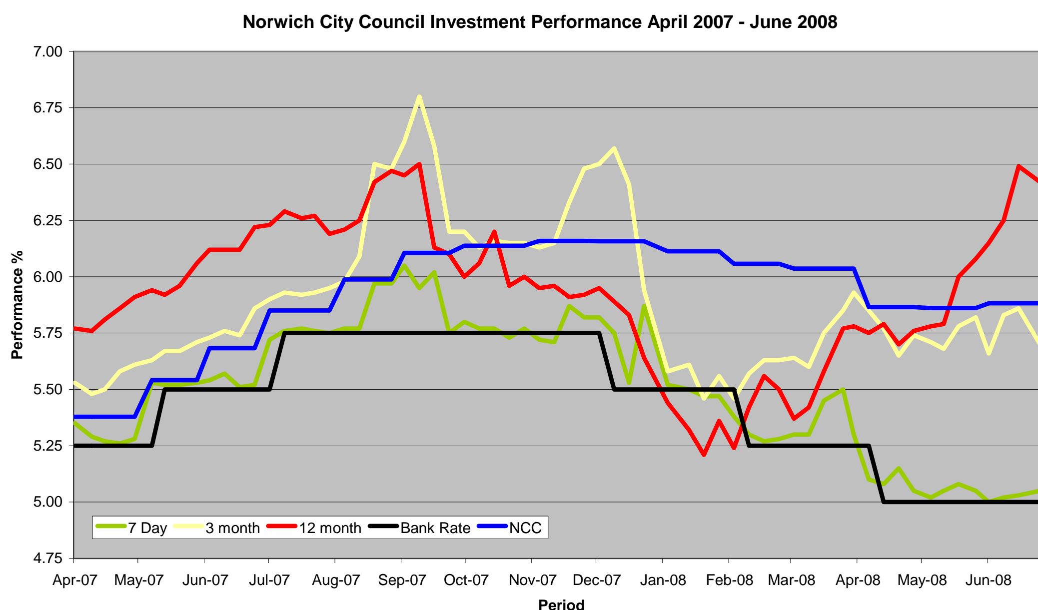
Month	Wtd Principal	Wtd Return	Cumulative Rtn	Benchmark	Net Performance	Av Investment Length	Max Investment Length
April – 07	£ 18,606,314.50	5.378%	5.378%	5.285%	0.094%	32	366
May	£ 29,070,756.77	5.541%	5.461%	5.484%	0.057%	88	1097
June	£ 32,623,232.74	5.683%	5.534%	5.548%	0.135%	35	367
July	£ 37,897,112.90	5.850%	5.614%	5.792%	0.058%	50	1096
August	£ 37,719,404.84	5.988%	5.690%	5.920%	0.069%	69	1098
September	£ 33,045,733.33	6.106%	5.758%	5.887%	0.219%	36	369
October	£ 37,968,937.90	6.138%	5.813%	5.764%	0.374%	68	366
November	£ 39,735,566.37	6.159%	5.856%	5.791%	0.368%	53	365
December	£ 40,773,681.61	6.157%	5.890%	5.666%	0.491%	29	364
January -08	£ 40,178,880.65	6.113%	5.912%	5.503%	0.610%	36	369
February	£ 36,939,636.55	6.057%	5.925%	5.307%	0.750%	1	3
March	£ 33,992,562.68	6.036%	5.934%	5.334%	0.702%	44	337
April	£ 34,975,367.50	5.865%	5.865%	5.070%	0.795%	79	732
May	£ 34,893,680.65	5.861%	5.863%	5.041%	0.820%	176	1463
June	£ 32,787,652.67	5.882%	5.869%	5.055%	0.827%	17	273

There is a clear correlation between the benchmark and investments made with the Co-op / DMO whose own performance for the two periods was 5.552% and 5.015%. Although not a major concern, the heavy reliance on investments with these two organisations has clearly acted as a drag on overall performance.

The graph below charts relative performance not just against the 7 day benchmark, but also Bank Rate, 3 month and 12 month rates. It clearly shows the significant dislocation between street and official rates for 3 and 12 month rates in particular. The 7 day rate was affected, but by no means to the same degree.

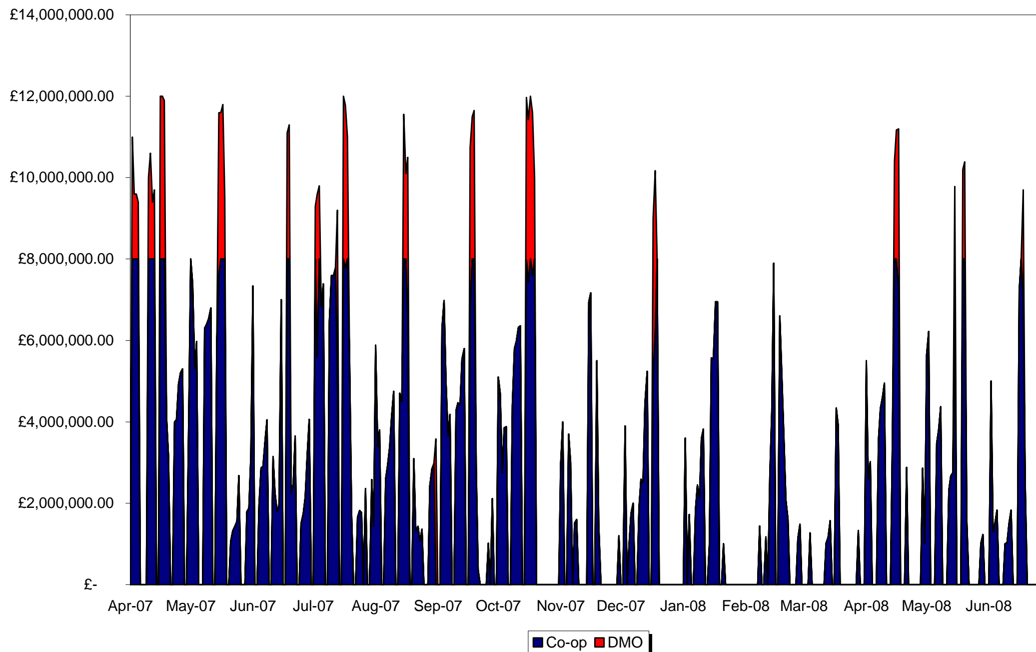
The graph also outlines how the average investment length of the Council impacted on performance. This was much in line with both the 7 day and Bank Rate until the end of July and then shifted to a higher level through to December 2007. Overall performance then tailed off as period rates fell, but the longer term aspect of some investments made during 2007-08 helped keep the overall rate relatively high.

The stability of the 3 month rate in the first quarter of 2008-09 is reflected in the Council's return for the period. However, the bulk of investments made for 1 year and beyond took place before these rates hit their highs in the latter stages of the review period. Nevertheless, the performance level remains firmly above the benchmark rate and will likely stay there for the remainder of 2008-09.



The final area to review in more detail is the continued reliance on Co-op and the DMO for the bulk of the Council's investments. As mentioned above the overall impact on performance for the review period has not been significant. However, if the large dislocation between Bank Rate / 7 day rate remains in place for most of 2008-09 then the impact could become more noticeable.

The graph below shows the level of investments made with the two organisations over the period. Until October 2007, there was almost constant investment with Co-op in particular. It has tailed off in the second part of the period, but there are still significant sums being placed.

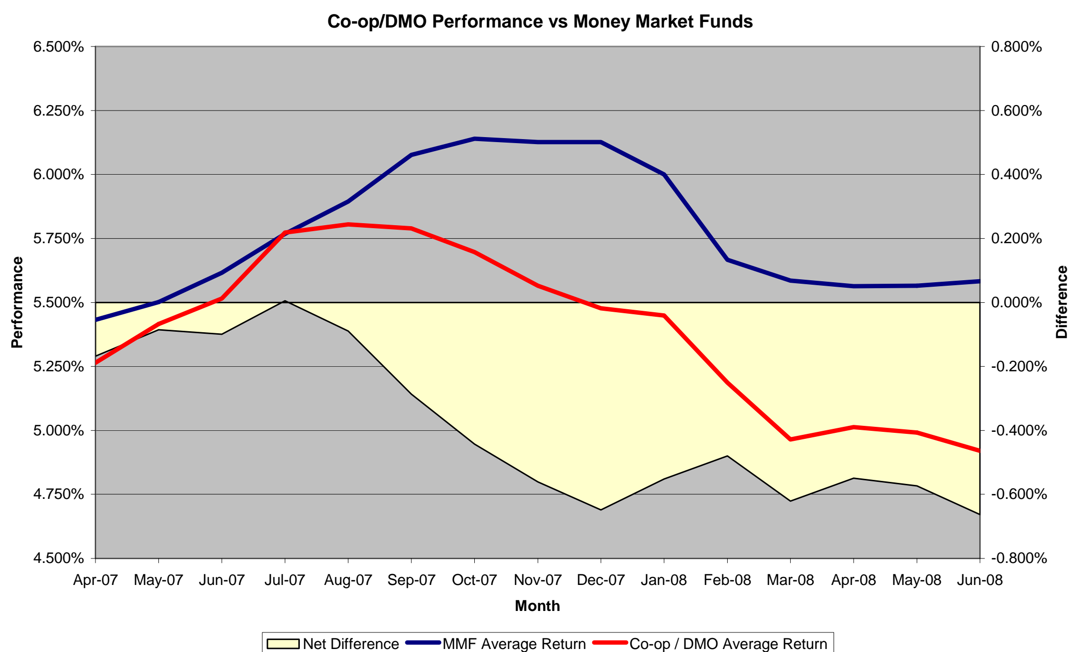


Alternative investments would have to offer good security, similar levels of liquidity, but higher returns. Bearing these criteria in mind we would suggest that the Council explores the use of Money Market Funds. These are open ended investment vehicles that represent vast pools of liquidity invested by a manager in a very wide range of money market instruments. The type and maturity distribution of these instruments is controlled and monitored by the official rating agencies and are key criteria upon which a fund is assigned and maintain its rating. The size of the liquidity pool, which in many cases amount to billions of pounds, places the manager in a position where it can offer to the user the flexibility of overnight and call money but the stability and more attractive returns of longer-dated deposits.

Strict rules and criteria are set down by the rating agencies. These cover important issues such as the type of investment counterparty used, the maturity distribution of funds and investment concentrations. In the majority of cases, these guidelines ensure a AAA rating for a fund which, together with the requirement that they are denominated in sterling and are regulated by officially recognised EU body, form the three fundamental criteria that make them eligible for local authority use. The fact that most funds are not registered in the UK is not considered relevant by the legislators, which is just as well, as only one is and it is not a prominent participant in this area.

The graph below compares performance between the Council's Co-op / DMO investments and MMFs. The MMF returns are gross as fee levels vary between funds, but in general terms they would be around 15bps.

The credit crunch has had a significant impact on MMFs. There has been huge influx of money placed in the funds. This has occurred for two reasons. First is the increased level of security these funds offer compared to investing in single entities and secondly is that performance (due to heavy investing in money market instruments) has been markedly improved by the dislocation between street and official rates.



Between August 2007 and June 2008 the average level of outperformance has been just short of 50bps. Even taking fees into account, this represents a significant markup compared to what the Council has undertaken. Looking forward, it is likely that the divergence between official and street rates will continue for some time and as such this is not an opportunity missed, but a potential opportunity to take advantage of.

The 2008-09 Strategy does allow for the use of MMFs. Limits are set at £4m per fund. Looking at the profile of investments for this review period, the Council would likely need to open more than one Fund. Either that, or it would need to go back to Full Council to get the limit altered. Given that Co-op has an £8m limit, this should not represent an issue for Members.

Conclusions

Overall, the Council's investment performance for the period under review has been good compared to its benchmark. The forecast for the remainder of 2008-09 would suggest that this positive position versus the benchmark will be maintained. The type of investments made and overall investment structure has not differed markedly from previous years, but the economic and market background has and this is the main reason for the outperformance level.

It is likely that the spread between official and street rates will narrow over time. The Council continues to use deals where rates are refixed at designated periods (ie 1yr deal with 3m "fixes"). In this falling rate market scenario it would be more beneficial to invest in "full term" deals rather than those whose rate would be refixed at various stages.

We have recommended to all clients that when investing beyond one year, they should look to only use counterparties with "AA" long term ratings. We would suggest Norwich uses this. It may mean settling for a lower level of return, but this would be more than compensated by the extra security a better rated counterparty can offer. The need for funds has drawn a number of highly-rated counterparties into providing good terms for small-sized deals and the Council should consider these if it is to make further long term investments in 2008-09.

Our final recommendation is that the use of alternative short-term instruments are explored. This has been outlined in more detail above. As with the other suggestions, we would be happy to discuss these in greater depth with officers when required.

Dan Willson
August 2008

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