

Pension Fund Committee

18th December 2007

Statement of Investment Principles



Report of Stuart Crowe County Treasurer

Purpose of the Report

1. To present a proposed updated Statement of Investment Principles for approval.

Background

2. Under Regulation 9A of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998, an administering authority, must after consultation with such persons as they consider appropriate, prepare, maintain and publish a written statement of the principles governing their decisions about investments (SIP).

The statement must cover their policy on a number of matters including:

- The types of investments to be held.
- The balance between different types of investments.
- Risk.
- Expected return.
- Realisation of investment.
- The extent (if at all) to which social, environmental or ethical considerations taken into account and the relation to investment.
- The exercise of voting rights attaching to investments, if they have any such policy.

The administering authority is about to sign contracts for the new investment managers and that contract expects the managers to take into account the Statement of Investment Principles when investing the portfolio with which they have been entrusted.

During the course of the contract negotiations it is clear that the new investment managers wish to have some certainty about the contents of the Statement of Investment Principles before they finally sign the contract and the restructuring of the fund requires that the SIP be revised to reflect the structure of the fund.

The draft at Appendix 1 has been circulated to all the investment managers, employers, the actuary, custodian and our own advisers.

This meeting was requested to enable Members to consider the Statement of Investment Principles before the contracts are finally signed.

Members will note from the draft SIP as set out in the report and the bench marks for each fund are also detailed.

At the time of the preparation of this report, some investment managers were still dealing with fine points on the contract, and on the SIP. As it is not unusual for last minute points to be raised up to the final signing of the contract, the recommendation in this report proposes a delegation to the Treasurer to make any amendments he considers appropriate, taking into account any late comments from the Investment Managers

Recommendation

3. That the Committee approve the SIP in its current form, but authorise me to make any amendments he considers appropriate after taking into account comments from the investment managers and the independent advisers.

Contact: Stuart Crowe – 0191 383 3550

10th December 2007
p/reports/ct11-07pfc



Pension Fund

Statement of Investment Principles

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INTRODUCTION

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (the “Regulations”) require administering authorities to prepare and review a written statement recording the investment policy of the Pension Fund. The regulations also require pension fund administering authorities to state the extent to which they comply with the Chartered Institute of Public Finance (CIPFA) Pensions Panel Principles for Investment Decision Making in the Local Government Pension Scheme in the United Kingdom. The compliance statement is attached at Appendix A.

Durham County Council is the administering authority (the “Authority”) for the Durham County Council Pension Fund (the “Pension Fund”) and the purpose of this document is to outline the broad investment principles governing the investment policy of the Pension Fund, thereby satisfying the requirements of the Regulations.

INVESTMENT RESPONSIBILITIES

The County Council, as Administering Authority, has delegated the investment arrangements of the Pension Fund to the Pension Fund Committee (the “Pension Fund Committee”) who decide on the investment policy most suitable to meet the liabilities of the Pension Fund and the ultimate responsibility for the investment policy lies with it. The Committee is made up of elected representatives of the County Council, Darlington Borough Council and District Councils, as nominated by the Durham County District Council’s Association.

The Pension Fund Committee has full delegated authority to make investment decisions.

The Pension Fund Committee has responsibility for:

- Determining overall investment strategy and strategic asset allocation and ensuring that investments are sufficiently diversified, are not over concentrated in any one type of investment, and that the Pension Fund is invested in suitable types of investments;
- Preparing policy documents including the Statement of Investment Principles. Monitoring compliance with the Statement and reviewing its contents following any strategic changes and at least every three years;
- Appointing the investment managers, custodian, the Pension Fund actuary and any independent external advisers felt to be necessary for the good stewardship of the Pension Fund;
- Reviewing on a regular basis the investment managers’ performance against established benchmarks, and satisfying themselves as to the investment managers’ expertise and the quality of their internal systems and controls;
- Reviewing on a regular basis the performance of the independent external advisers;
- In cases of unsatisfactory performance of the investment managers and independent external advisers, taking appropriate action;
- Reviewing policy on social, environmental and ethical matters and on the exercise of rights, including voting rights; and
- Reviewing the resources allocated to investment managers on a regular basis.

The investment managers are responsible for:

- The investment of the Pension Fund assets in respect of which they are appointed in compliance with applicable rules and legislation, the constraints imposed by this document and the detailed Investment Management Agreement covering their portion of the Pension Fund’s assets;

- Stock selection within asset classes;
- Preparation of quarterly reports, including a review of investment performance;
- Attending meetings of the Pension Fund Committee as requested;
- Assisting the County Treasurer and Pension Fund Committee in the preparation and review of this document; and
- Where specifically instructed, voting in accordance with the Pension Fund's policy.

The Global Custodian is responsible for:

- Its own compliance with prevailing legislation;
- Providing the administering authority with quarterly valuations of the Pension Fund's assets and details of all transactions during the quarter;
- Collection of income, tax reclaims, exercising corporate administration and cash management;
- Such other services as the Pension Fund shall procure, for example, in connection with performance measurement and reporting or fund accounting.

The Independent Advisers are responsible for:

- Assisting the County Treasurer and Pension Fund Committee in determining the overall investment strategy, the strategic asset allocation and that the Pension Fund is invested in suitable types of investment, and ensuring that investments are sufficiently diversified.
- Assisting the County Treasurer and Pension Fund Committee in the preparation and review of Policy documents;
- Assisting the County Treasurer and Pension Fund Committee in their regular monitoring of the investment managers' performance;
- Assisting the County Treasurer and Pension Fund Committee in the selection and appointment of investment managers, custodians and Pension Fund Actuary;
- Advising and assisting the County Treasurer and the Pension Fund Committee on other investment related issues, which may arise from time to time; and
- Providing continuing education and training to the Pension Fund Committee.

The Actuary is responsible for:

- Providing advice as to the structure of the Pension Fund's liabilities, the maturity of the Pension Fund and its funding level in order to aid the Pension Fund Committee in balancing the short term and long-term objectives of the Pension Fund.
- Undertaking the statutory triennial valuation of the Fund's assets and liabilities.

The County Treasurer is responsible for:

- Ensuring compliance with this document and bringing breaches thereof to the attention of the Pension Fund Committee;
- Ensuring that this document is regularly reviewed and updated in accordance with the Regulations;
- Exercising delegated powers granted by the County Council to:
 - Administer the financial affairs in relation to the County Council's functions as a pension fund administering authority;
 - Exercise those discretions under the Local Government Pension Scheme Regulations 1997 as appear from time to time in Pension Fund Statements of Policy; and
 - Authorise, in cases of urgency, the taking of any action by an investment manager of the Pension Fund which is necessary to protect the interests of the Pension Fund.

AUTHORISED INVESTMENTS

The powers and duties of the Authority to invest monies are set out in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 as amended from time to time. The Authority is required to invest any money which is not required immediately to pay pensions and any other benefits and, in so doing, take account of the need for a suitable diversified portfolio of investments and the advice of persons properly qualified on investment matters.

Types of Investment

Investment can be made in accordance with the regulations in a broad spectrum of investments such as equities, fixed interest and other bonds, collective investment schemes, deposits, money market instruments, unquoted equities and property, both in the UK and overseas. The regulations also specify other investment instruments that may be used such as stock lending, financial futures, traded options, insurance contracts, sub underwriting contracts and a contribution to an unquoted limited liability securities investment partnership.

The limits on the amount of money that can be invested in each individual type of investment are specified in schedule 1 of the Regulations. We do not participate in stock lending or underwriting.

The Local Government Pension Scheme (Management and Investment of Funds) (Amendment) Regulations 2003 amended the regulations so as to give Authorities the option to increase some of the limits on certain types of investments provided that the Authority complies with the requirements of the Regulations. These requirements include taking proper advice, the suitability of particular investments and types of investments, the limit on the amount of such investment, the reason for such investment and the period for which the increase in the limit of the type of investment will apply. Any increase in the limit must be kept under review.

Investment Managers are instructed to comply with the regulations in respect of the relevant portfolio subject to any specific instructions. The Authority is responsible for oversight of how compliance affects the compliance of the Pension Fund as a whole.

Investment Risk

The investment policy has been set with the objective of controlling the risk that the assets will not be sufficient to meet the liabilities of the Pension Fund while achieving a good return on investment.

Dividing the management of the assets between six investment managers, further controls risk. Asset allocation benchmarks have been set and performance is monitored relative to the benchmarks. This is to ensure the investment manager does not deviate from the Pension Fund Committee's investment strategy.

The setting of specific control ranges and other investment guidelines within which the investment managers must operate also controls risk.

Realisation of Investments

The vast majority of the Pension Fund's investments are readily marketable and may be easily realised if required. Some investments may be less easy to realise in a timely manner but the total value of these types of investments is not considered to have any adverse consequences for the Pension Fund.

Approval has been given to investment as follows:

In-House Management

i. Midland Enterprise Fund for the North East Exempt Unit Trust

- Small, private and growing companies in the North East of England:

- £200,000 invested.

ii. Capital North East

- Start up and development capital for businesses in the North East:
- £400,000 invested, up to £500,000 may be invested.

External Investment Management

The Pension Fund Committee has appointed six investment managers to manage the remainder of the Pension Fund's assets. They have been appointed under the terms of the Regulations and their roles are described in the Investment Policy in Appendix B.

ALLOCATION STRATEGY

Having considered advice from the Independent Advisers, and also having due regard for the objectives, the liabilities of the Pension Fund and the risks facing the Pension Fund, the Pension Fund Committee have decided upon the following strategic target asset allocation:

Asset Class	Permitted Assets	Benchmark & Performance Target	Proportion of Total Fund *
Conventional Bonds	Investment grade sterling bonds	FTSE Over 5 Year Index-Linked Gilt Index +0.5%	20%
Broad Bonds	Global bonds	UK 3-month LIBOR +3.0%	16%
UK Equity	UK equities	FTSE All Share Index +3.0%	20%
Global Equities	Global Equities	MSCI AC World Index +3.0%	28%
Dynamic Asset Allocation	All major asset classes with derivative overlay	UK 3-month LIBOR +4.0%	8%
Global Property	Global property	UK Retail Price Inflation +5.0%	8%

* Excluding in-house managed funds

More detailed definitions of the mandates are given at Appendix B.

The Pension Fund Committee and the County Treasurer, in conjunction with the Independent Advisers, will formally monitor the actual asset allocation of the Pension Fund on a quarterly basis.

STOCK SELECTION

Individual investments are chosen by the Investment Managers with the Pension Fund Committee, County Treasurer and independent external advisers able to question the investment managers on their actions at each quarterly meeting.

INVESTMENTS REQUIRING PRIOR APPROVAL

Subject to changes and agreements with Investment Managers, as included at Appendix B, a detailed report must be submitted to and approved by the Pension Fund Committee prior to making investments in the following:

- Venture capital
- Commodities
- Stock lending
- Currency Hedging - Agreed in principle, subject to prior consultation with the County Treasurer.

SOCIALLY RESPONSIBLE INVESTING

The Pension Fund Committee must act with the best financial interests of the beneficiaries, present and future, in mind. The Pension Fund Committee believes that companies should be aware of the potential risks associated with adopting practices that are socially, environmentally or ethically unacceptable. As part of the investment decision-making process, Investment Managers are required to consider such practices and assess the extent to which this will detract from company performance and returns to shareholders.

CORPORATE GOVERNANCE

Investment Managers are required to exercise voting rights on behalf of the Pension Fund when it is in the best interests of the Pension Fund. The quarterly report from investment managers should include details of voting activity.

FEE STRUCTURE

Investment Managers' fees are based on the value of assets under management. In the case of five investment managers, a performance related fee structure is in place based on a base fee plus a percentage of out-performance. In the case of the remaining investment manager an ad-valorem fee is payable.

Independent Advisers' fees are based on a retainer for attendance at Pension Fund Committee and Annual Meetings and the provision of advice to the Pension Fund Committee. Fees for any additional work is based on a daily or hourly rate, as provided for by agreement.

Any additional work will be subject to a suitable fee arrangement or subject to separate tendering exercises.

REPORTING REQUIREMENTS

The investment managers must report quarterly on matters covered in their individual agreements, but should include common items such as:

- Investment Managers' views on the UK or other relevant economies and the proposed asset allocation for the past, present and future quarter.
- Reports on any new investment policy issues requiring the approval of the Pension Fund Committee.
- Performance during the previous quarter, previous twelve months, three years and five years.
- Investment transactions schedule for the previous quarter.
- A Portfolio valuation, including details of individual holdings.
- Portfolio distribution and the changes in the markets - summarised by:
 - type of investment;
 - sector
 - geographic area as appropriate.
- Performance of any collective investment funds or internal pooled funds in which investments are held.
- Underwriting commitments relevant to the Portfolio.
- The cash position of the Pension Fund.
- Voting actions and forthcoming activity.
- Any material matters reported to the Financial Services Authority (FSA) in respect of the Portfolio or which reasonably might be brought to the attention of the Pension Fund Committee.
- Any material matters in respect of the interface with the Custodian.
- Investment or ancillary activities carried out in relation to the Portfolio where there arose a material risk of damage to the interests of the Pension Scheme or where a material risk of damage may arise in the future.
- Dealing errors and action taken.
- Any breach of confidentiality.
- Any breach of this Agreement.

Annually, the Global Custodian must present a detailed report relating to the individual investment managers' fund performance and the combined fund performance.

- Principles

This appendix sets out the extent to which Durham County Council as the Administering Authority of the Durham County Council Pension Fund complies with the ten principles of investment practice set out in the document published in April 2002 by CIPFA, the Chartered Institute of Public Finance and Accountancy, and called "CIPFA Pensions Panel Principles for Investment Decision Making in the Local Government Pension Scheme in the United Kingdom" (Guidance note issue No. 5).

Principle 1 — Effective decision-making

Fully compliant: Investment decisions are made by those with the skill, information and resources necessary to take them effectively. A programme covering investment issues is being developed for new members joining the Pension Fund Committee and training is provided to all members.

Principle 2 – Clear objectives

Fully compliant: The overall investment objective for the Pension Fund is set out in the Funding Strategy Statement.

Principle 3 – Focus on asset allocation

Fully compliant: All major asset classes are considered. An asset liability modelling exercise is being considered as part of the ongoing review of the administration of the Pension Fund.

Principle 4 – Expert advice

Fully compliant: Two independent advisers were appointed in November 2004. Actuarial services have been subject to a separate open tender process.

Principle 5 – Explicit mandates

Fully compliant: Explicit written mandates agreed with all investment managers. Investment managers have been asked to report on transaction costs and commission.

Principle 6 – Activism

Partial compliance: Investment Managers are required to exercise voting rights on behalf of the Pension Fund when it is in the best interests of the Pension Fund. Normal practice is to allow the Investment Managers to follow their in-house voting policy unless otherwise instructed by the Pension Fund Committee. The mandates do not specifically incorporate the principle of the US Department of Labor Interpretative Bulletin on activism.

Principle 7 – Appropriate benchmark

Fully compliant: Appropriate benchmarks have been set in consultation with the independent advisers and the actuary.

Principle 8 – Performance measurement

Partial compliance: Performance of the Pension Fund is measured; separate monitoring of Pension Fund Committee performance and independent adviser performance has yet to be established.

Principle 9 – Transparency

Fully compliant: Investment objective and asset allocation strategy covered in the Funding Strategy Statement or Statement of Investment Principles. Investment Manager and independent adviser fee structures are included.

Principle 10 – Regular reporting

Fully Compliant: The Funding Strategy Statement including the Statement of Investment Principles is available on the internet and is included in the Pension Fund's Annual Report and Accounts. A summary of overall Pension Fund performance is reported to members of the Pension Fund annually.

- Investment Managers

The Pension Fund Committee has appointed six Investment Managers: Edinburgh Partners Limited ('Edinburgh Partners'), BlackRock Investment Management (UK) Limited ('BlackRock'), AllianceBernstein Limited ('AllianceBernstein'), Royal London Asset Management ('RLAM'), CB Richard Ellis Collective Investors Limited ('CBRE') and Baring Asset Management Limited ('Barings') to manage the assets of the Pension Fund.

The long-term strategic allocation is as follows (the actual allocation may vary due to market movements):

Investment Manager	%	Asset Classes	Investment Style
Edinburgh Partners	28	Global Equities	Active
BlackRock	20	UK Equities	Active
AllianceBernstein	16	Global Bonds	Active
RLAM	20	Investment grade sterling bonds	Active
CBRE	8	Global Property	Active
Barings	8	Dynamic Asset Allocation – All major asset classes with derivative overlay	Active

The investment restrictions detailed in this Appendix form part of the contractual agreement with Investment Managers and will only be varied after consultation with the Investment Managers in accordance with their contracts.

The Investment Manager may hold cash up to the value of 5% of the market value of the portfolio in respect of which the Investment Manager has been appointed, subject to agreements with individual Investment Managers, who may require a different limit to invest their part of the Pension Scheme's assets. Cash in excess of this value should be returned to Durham County Council as Administering Authority.

The mandates for each Investment Manager, subject to the overall requirements of the Regulations and this Statement of Investment Principles, are as follows:

Edinburgh Partners

The Pension Fund Committee has appointed Edinburgh Partners to manage a portfolio to be invested in Global Equities.

The Investment Manager's objective is to outperform the benchmark by 3% per annum net of fees over 3 year rolling basis.

The benchmark allocation is as follows:

Asset Class	Benchmark
Global Equities	MSCI AC World Index

Edinburgh Partners intend to invest in the following to achieve their objective:

Portfolio	%
EP Global Equity	100

Edinburgh Partners have a number of guidelines in place at the regional, sectoral and stock level when considering the control of risk within the portfolio. These are detailed below:

Sector	Range
Number of Stocks	Typically holding 30 to 50 stocks
Maximum holding in one stock	5% of the portfolio's value at time of investment. With market movement max. 7.5% before reduction in holding
Holding in cash	Typically not expected to exceed 5% of the portfolio's value following the initial investment process
Maximum holding in one sector	Diversified (e.g. Financials/Industrials) 40% Partially Diversified (e.g. Consumer Goods) 30% Homogeneous (e.g. Oil) 20%
Maximum holding in any one country	US, Japan, UK max 50% each Other developed markets max 20% each Emerging Market Country (as defined by MSCI Emerging Markets Index) max 10% each

BlackRock

The Pension Fund Committee has appointed BlackRock to manage a portfolio to be invested in UK Equities.

The Investment Manager's objective is to outperform the benchmark by 3% per annum net of fees over a rolling three year basis.

The benchmark allocation is as follows:

Asset Class	Benchmark
UK Equity	FTSE All-Share Index

BlackRock intend to invest in the following to achieve their objective:

Portfolio	%
UK Focus approach	100

While the BlackRock UK Focus Fund is unconstrained there are some guidelines within the investment process in respect of the portfolio. These guidelines are set out below:

Sector	Range
No. of stocks	Typically holding 15 to 30 stocks
Maximum holding in one stock	15% of the portfolio's value
Maximum holding in one sector	No maximum limit
Holding in cash	Typically not expected to exceed 2% to 5% of the fund value
Active risk	Expect the ex-ante tracking error (active risk) to fall within the range 5% pa to 11% pa.

AllianceBernstein

The Pension Fund Committee has appointed AllianceBernstein to manage a portfolio to be invested in Global Bonds.

The Investment Manager's objective is to outperform the benchmark by 3% per annum net of fees over a rolling three year basis, with 5 – 10% volatility.

The benchmark allocation is as follows:

Asset Class	Benchmark
Broad Bonds	UK 3-month LIBOR

AllianceBernstein intend to invest in the following to achieve their objective:

Portfolio	%
Diversified Yield Plus Fund	100

Alliance Bernstein can use a wide variety of financial instruments to generate returns within the portfolio. The limits to what extent they can invest in each are detailed below:

Sector	Range
High Yield	0% to 30%
Bank Loans	0% to 25%
Emerging Markets	0% to 20%
Foreign Exchange	0% to 30% gross, 0% to 15% net
Sovereign	0% to 100%
MBS	0% to 40%
CMBS/ABS	0% to 30%
Investment-Grade Corporates	0% to 75%

RLAM

The Pension Fund Committee has appointed RLAM to manage a portfolio to be invested in Investment Grade Bonds.

The Investment Manager's objective is to outperform the benchmark by 0.5% per annum net of fees over a rolling three year basis.

The benchmark allocation is as follows:

Asset Class	Benchmark
Conventional Bonds	FTSE Over 5 Year Index-Linked Gilt Index

RLAM intend to invest in the following to achieve their objective:

Portfolio	%
Long Aggregated Bond Fund	100

RLAM can invest in a wide variety of bonds to generate returns within the Fund. The constraints to what extent they can invest in each are detailed below:

Bond classification	Range
UK Government Index Linked Bonds	50% to 100%
Overseas Government Index-Linked Bonds*	0% to 20%
UK Non-Government Index Linked Bonds	0% to 20%
UK Conventional Government Bonds	0% to 20%
UK Investment Grade Corporate Bonds (or equivalent)	0% to 20%
Overseas Conventional Bonds**	0% to 10%
Derivatives	0%
Cash or cash equivalents (less than 1 year maturity)	0% to 10%

*Includes government and non-government bonds

**Includes government and corporate bonds and Currency hedged into sterling.

Furthermore, the Durham County Council portfolio will have the following investment restrictions.

	Range
Duration	+/- 2 years
Limit in any single security*	Maximum of 5% of portfolio

*Excludes government bonds.

CBRE

The Pension Fund Committee has appointed CBRE to manage a portfolio to be indirectly invested in Property. Investment will not be restricted to UK vehicles, but can be invested on at least a pan-European basis.

The Investment Manager's objective is to outperform the benchmark by 5% per annum net of fees to be achieved over a five year time horizon.

The benchmark allocation is as follows:

Asset Class	Benchmark
Global Property	UK Retail Price Inflation

CBRE intend to invest in the following to achieve their objective:

Portfolio	%
CB Richard Ellis RPI +5%	100

There are limitations that apply with the construction of the CBRE portfolio. They are as follows:

Restrictions	Range
Maximum allocation to any single fund	0% to 15%
Maximum allocation to listed investments	0% to 30%
Maximum allocation to any single country (including the UK)	0% to 25%
Maximum regional allocations -	
Asia Pacific Region	0% to 40%
North American Region	0% to 40%
Other Regions (excluding Europe)	0% to 10%

Barings

The Pension Fund Committee has appointed Barings to manage a portfolio to be invested in a fully diversified Global portfolio. It is expected that target return will be delivered using dynamic asset allocation over the market cycle incorporating the full range of global investment opportunities.

The Investment Manager's objective is to outperform the benchmark by 4% per annum net of fees over a rolling three year basis, with 5 – 10% volatility.

The benchmark allocation is as follows:

Asset Class	Benchmark
DAA	UK 3-month LIBOR

Barings intend to invest in the following to achieve their objective:

Portfolio	%
Extended Risk Solutions	100

Barings can use a wide variety of asset classes to generate returns within the Fund. The constraints to what extent they can invest in each are detailed overleaf:

Asset Class	Range
Equities (segregated and/ or pooled)*	0% to 65%
Commodities*	0% to 30%
Bonds	0% to 80%
Investment-Grade Corporate Bonds	0% to 50%
High Yield**	0% to 15%
Emerging Market Debt**	0% to 15%
Property	0% to 30%
Hedge Funds/Structured Products/Private Equity	0% to 50%
Foreign Exchange	0% to 40%
Cash/Near Cash	0% to 25%

* Equities and Commodities, aggregate maximum 80%

** High Yield and Emerging Market Debt, aggregate maximum 20%

Note: Allocations to other bond assets such as mortgage backed securities or asset backed securities and bank loans as well as foreign currency exposure are also permitted.

The Pension Fund Committee will allow the Investment Manager to exercise Long/Short strategies; however there will be no net short positions permissible in any asset class.

Furthermore, Barings are precluded from investing in any of the funds that AllianceBernstein are running on behalf of the Pension Fund.