Appendix 2

Cherwell District Council

Fund Manager Review: January to March 2009

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Summary

The latest quarter saw no let up in the volatile and unpredictable behaviour of markets that has dominated most of the past two financial years. Economies around the world sank into deep recession and public sector finances deteriorated at an accelerating rate as governments sought to prop up beleaguered manufacturing and service sectors and to support financial organisations under severe pressure.

Official interest rates continued on their downward path. US interest rates had been cut to near zero in late December 2008, so the main running was taken up by the Bank of England and to a lesser extent by the European Central Bank. By the close of the quarter, UK official rates had fallen to 0.5%, a level that was unlikely to be bettered.

The latest cut in rates was followed by a significant departure of monetary policy, from the regulation of interest rates to quantitative easing. Growth in money supply as opposed to inflation was now viewed as the key determinant of MPC actions and this was more likely to affect the performance of long as opposed to short-term interest rates.

Money market rates followed a gradually easing trend, although the persistence of the atmosphere of fear and suspicion that had dominated the financial sector since 2007 continued to hamper liquidity and to prevent a more marked decline in interest rates.

This did mean that rates available on negotiable instruments remained substantially above short-term benchmarks and created some, albeit rather unexciting, investment opportunities. In addition, a gradual decline in longer-term money market rates did generate some capital gains but the best of these had been seen in the previous quarter.

Gilt-edged prices remained volatile and did enjoy the occasional phase of notable strength, no more so than after the announcement of the Bank of England's move to quantitative policy easing. But movements proved very unpredictable and fund managers treated the market with caution for fear that a bad decision would do much to erode hard-earned returns at a critical stage of the financial year.

In general, returns on the quarter were satisfactory if unspectacular. But the lack of major "accidents" meant that performances for 2008/09 as a whole were good. Unfortunately, the current low level of money market rates and gilt yields will limit the scope for generating good returns in the year ahead. The attributes of liquidity and security offered by the segregated investment funds will their principal attractions for the next year at least.

Summary data

	CDCM	Investec
Value of fund as at 31 March 2009	29,000,000	26,230,208.57
Percent net return on quarter	1.38	1.15
Cumulative net return 2008/09	5.51	7.27

The Council's two managers, Investec and CDCM, delivered very satisfactory returns over the quarter and consistently good results for the year as a whole. Investec was the top performer among its peers by a wide margin, while CDCM continued to deliver a steady profile ahead of benchmark by a decent amount.

Investec remained one of the more cautious of the wide range fund managers in the closing stages of the financial year. It continued to avoid exposure to the gilt-edged market for a number of reasons. First and foremost, yields had fallen by late 2008 to levels that were considered to be just about as low as they were likely to go. They did not offer good value and while holdings might be justified on grounds of safety, any adverse movements in price would compromise performance.

Second, the vulnerability of the market to adverse shifts in investor sentiment and the risk of suffering losses in the closing stages of the financial year served as a deterrent to tactical trading operations. The downside risks far outweighed the advantages that might be had from capital uplift which at the low level of market yields would most likely be small.

Too often in the past, Investec's decent performance for the first three quarters of the year has been undone by ill-timed forays into the gilt market. It was quite determined not to be caught out again this time.

Very few new investments were made in the quarter by either manager, courtesy of the fact that there were very few maturities. In fact, the only action taken by CDCM was to re-fix the "coupon" on a variable rate deposit with the Nationwide Building Society. Investec purchased two CDs with lives of three months.

Performance Comparisons - cumulative data

	Investec		**CDCM**	
(%)	vs 7-day LIBID	vs Ind Ave	vs 7-day LIBID	vs Ind Ave
2003/04	-1.18	-0.65	0.45	0.94
2004/05	0.13	0.03	0.32	0.16
2005/06	-0.10	-0.08	0.58	0.56
2006/07	-0.96	-0.28	0.37	0.97
2007/08	0.23	0.04	-0.27	-0.46
2008/09				
Jun	-0.08	0.06	0.09	0.23
Sep	0.02	-0.06	0.21	0.11
Dec	2.68	0.65	0.79	-1.28
Mar	3.67	0.79	1.94	-0.97

Over the quarter, Investec posted a net return of 1.15%, CDCM a gross return of 1.38%, results that compare with 0.23% for the benchmark and 1.03% for the industry average. The results for the year are very creditable, Investec's cumulative return of 7.27% beating its benchmark by 3.67% and the industry average by 0.79%. CDCM's 5.51% gross return exceeded its benchmark by 1.94%, although it was slightly short of a demanding average.

The task of delivering another upbeat return in the new financial year has been made doubly difficult by the fall in rates to very low levels. As existing high yield asset holdings mature, the proceeds will be invested in lower yielding instruments. CDCM's portfolio has a relatively lengthy maturity profile which suggests the fall in returns from this particular manager will be quite slow. For Investec, this will not be the case as most of the current high yield assets are redeemed over the course of the next six months. In addition, with opportunities to generate additional return in the gilt market very limited it would be unwise to expect miracles from this manager. Where it will continue to deliver is in its provision of access to quality counterparties and liquidity.

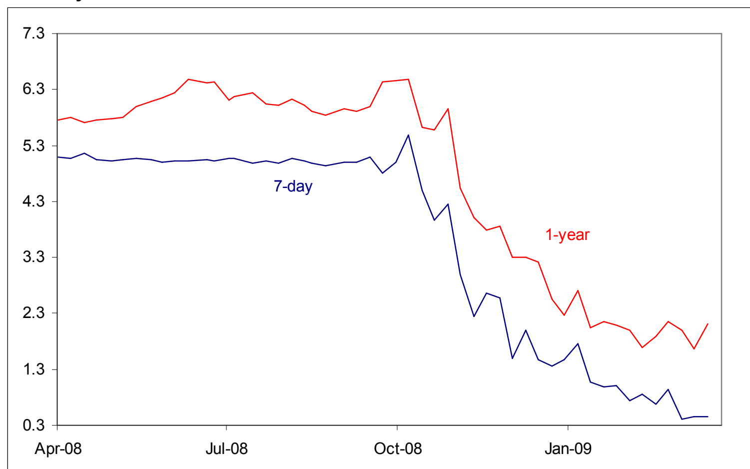
Market Background

The nervousness of the world's financial markets continued to dominate sentiment for a good deal of the past quarter, although by the end of the period there were a few signs that the situation was moving to a more stable footing. This had required a great deal of additional assistance by governments in the bulk of major industrialised countries at very considerable cost to budgets.

The New Year failed to herald a change in the fortunes of the banking sector. Hopes were pinned upon a more healthy set of quarterly performance results following all the asset write downs of the past year and the assistance packages that had been put in place in the preceding months. But this failed to materialise and the stream of bad news on profits and problem banks continued during the January/February reporting season.

Central banks continued to ease monetary policies in an attempt to reduce borrowing rates and hence alleviate some of the cost pressures being experienced by financial institutions and, more to the point, the corporate and household sectors. These latter areas were faced with an increasingly severe recession, triggered initially by the monetary squeeze courtesy of the credit crunch and asset price deflation.

Money Market Rates



With official interest rates in the US already at close to zero at end-2008, the Bank of England was at the forefront of policy easing. Bank Rate was cut in successive monthly moves from 2% at the outset of the year to the historically low level of 0.5% in March. Thereafter, the governor of the Bank indicated no further cuts were contemplated. Policy ease going forward would take the form of quantitative measures where the stock of money would be expanded via a mechanism of buying securities from investment institutions in exchange for cash. This so-called quantitative easing commenced in early March and is expected ultimately to amount to £150bn, the full amount sanctioned by the Chancellor of the Exchequer.

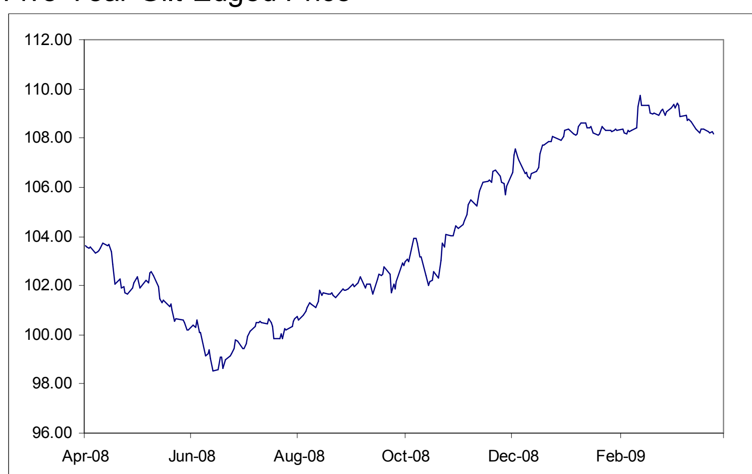
Aside from Bank of England assistance, the central government launched the second phase of its support operations for the banking industry during the second half of January. This failed to allay fears that even more aid might have to be extended to the banking industry before the crisis is over. During the course of the quarter, two major banks, RBS and Lloyds Group, needed substantial cash injections, action that led the public sector to assume near-full ownership. In addition to this, the Dunfermline Building Society was rescued from bankruptcy.

The problems of the financial markets since late 2007 had clearly spread to other parts of the economy. Economic data confirmed that the UK was in deep recession and the latest Bank of England Inflation Report (published in mid-February) registered a marked change in official forecasts for 2009 and 2010. Economic activity was expected to decline sharply (GDP was forecast to contract by more than 4% in 2009) and inflation was projected to fall into negative territory. Both these forecasts were seen as justifying the shift to a more aggressive approach to monetary policy.

The generally uncertain backdrop to the UK and the financial markets prevented a marked easing in overall money market liquidity. While the situation did show some signs of improving as the quarter progressed, the margin between official interest rates and those quoted in the inter-bank market for periods longer that 1-month remained very wide.

The gilt-edged market posted a generally satisfactory performance, although day-to-day price movements remained very erratic and difficult to predict. The attractions of this market as a safe haven for investment funds continued to exert a positive influence but the fall in yields to historically low levels did serve as a deterrent to significant inflows of new funds. This was particularly evident at the shorter end of the maturity range where yields had already declined to levels that had discounted the severe cuts in official interest rates.

Five-Year Gilt-Edged Price



Deteriorating growth prospects, fears of prolonged deflation and expectations that RPI inflation would sink to negative territory in the foreseeable future served as positive influences for this market. However, at least part of this was countered by the very severe deterioration in public sector finances. The prospect of exceptionally heavy supply of new gilts to finance the government deficit dampened investor enthusiasm and limited the extent to which any rallies could be sustained for more than a few days.

Prices did jump sharply higher in early March when the Monetary Policy Committee sanctioned the purchase of gilts as the mainstay of its quantitative easing (QE) programme. But the greatest gains were seen beyond the 5-year area, a function of the fact that the QE purchases by the Debt Management Office would be confined to securities with remaining lives of between five and twenty-five years. Prices eased back following this rally and the weight of forthcoming supply and the relative unattractiveness of gilt yields dampened buying interest.

Investment Activity

General Background

Fund managers continued to exercise caution in the uncertain financial environment mindful of the fact that counterparty viability remained in question and the number of attractive opportunities offered by financial instruments was dwindling in the face of declining money rates and yields.

A small number of managers did undertake a few tactical trades in the gilt-edged market with the aim of generating small but useful profits from anomalous price behaviour.

But the bulk of what activity there was, was directed towards capturing value for minimal risk. In the main this involved purchasing certificates of deposit with relatively short lives but did also feature investment in alternative instruments, notably bonds and floating rate notes issues by supranational organisations such as the European Investment Bank.

Distribution of Investments (% distribution of portfolio)

End-period	Money market						Gilts	OFI
Month	U/i cash	0-1 month	1-3 month	3-6 month	6-12 month	over 1yr		
CDCM								
2008 Mar	0.00	0.00	8.62	0.00	34.48	56.90	0.00	
Jun	0.00	0.00	0.00	17.24	20.69	62.07	0.00	
Sep	0.00	0.00	0.00	17.24	12.07	70.69	0.00	
Dec	0.00	0.00	17.24	3.45	25.86	53.45	0.00	
Mar	0.00	13.79	8.62	8.62	25.86	43.10	0.00	
Investec								
2008 Mar	0.18	0.00	27.87	33.30	38.64	0.00	0.00	0.00
Jun	0.41	4.13	28.77	18.63	48.06	0.00	0.00	0.00
Sep	0.37	18.66	0.00	30.03	46.11	4.83	0.00	0.00
Dec	0.22	0.77	3.65	27.89	62.50	4.98	0.00	0.00
Mar	0.38	10.43	21.55	18.10	44.51	5.02	0.00	0.00

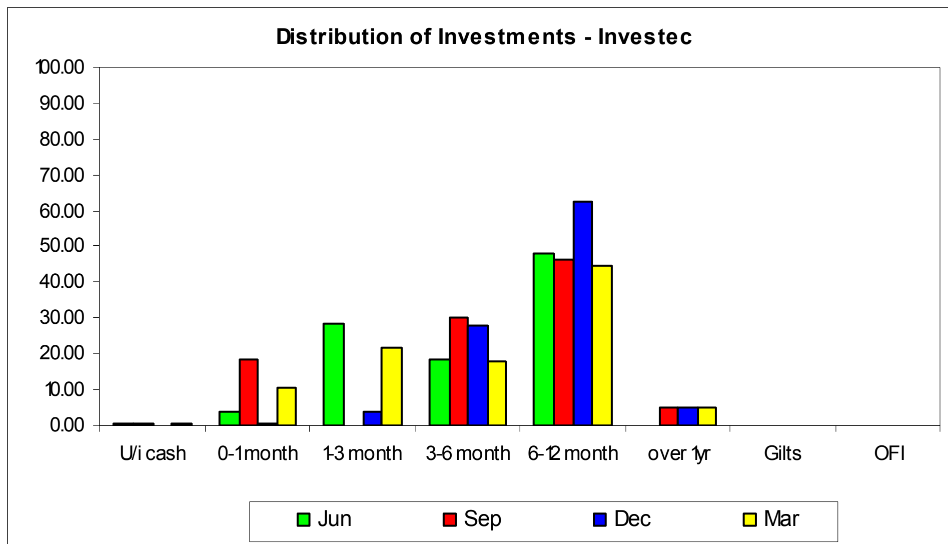
Investec

Investec remained one of the more cautious of the managers. This has been a feature of this manager for the past year and a half and is a far cry from its more adventurous approach in past years.

One reason for this style is the manager's determination not to give up hard-earned return via ill-timed forays into areas such as the gilt-edged market in the closing stages of the financial year, an all too familiar pattern earlier in the decade.

Activity was low key and tended to feature the reinvestment of funds arising from the maturity of existing security holdings. The low level of yields and lack of interesting opportunities across the maturity range meant there was no real incentive to undertake early switching operations.

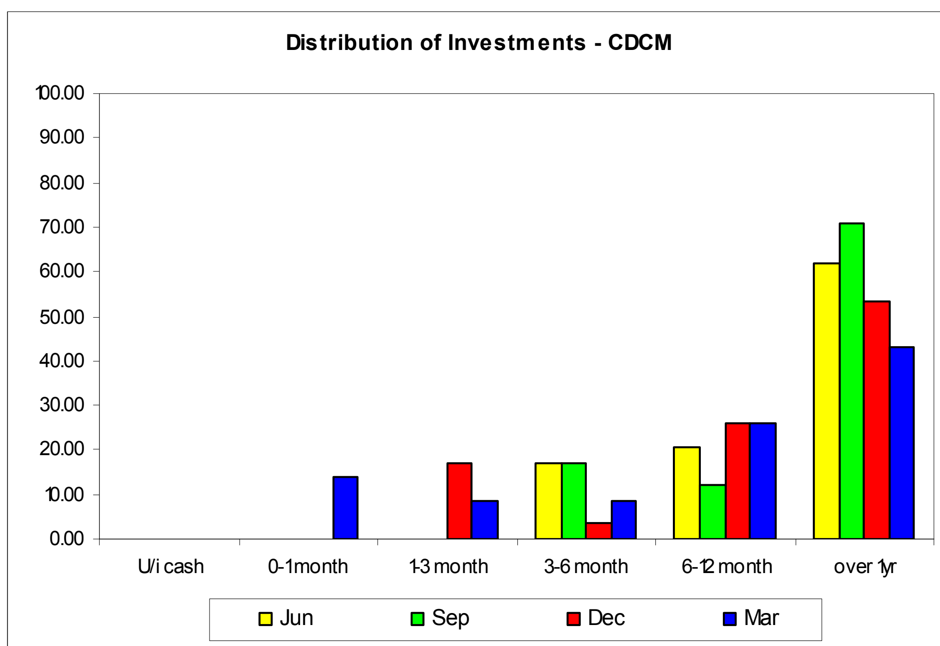
For the Council's fund, activity was confined to the purchase of CDs in the three month area for yields around 2%, actions that do not bode especially well for absolute returns as the new financial year progresses.



CDCM

Strong expectations that interest rates will return to a rising path by early 2010 was the principal driving force behind the manager's investment approach in the quarter. Where new investments were undertaken they were confined to the shorter end of the maturity range to ensure there will be plenty of flexibility within the portfolio to capitalise upon a rise in interest rates when it occurs.

No new investments were undertaken for the fund during the quarter. The variable rate deposit with the Cheshire Building Society (now Nationwide) was re-fixed for a further three months at 2.66%.



Performance

General Overview

Declining yields in the money and gilt-edged markets hampered managers' ability to add value via new security purchases. Nevertheless, the performances of the segregated managers remained satisfactory and well ahead of LIBID benchmarks.

This was almost exclusively the result of earlier acquisitions of longer-dated securities on yields close to and in some cases above 6%. The longer the duration of these instruments the greater the sensitivity of their prices to changes in market yields and the larger the potential capital uplift in the times of falling interest rates.

Lack of high profile "accidents" in the gilt-edged market limited the number of times managers posted disappointing quarterly returns and ensured the results for the financial year as a whole were good.

Comparative performances against benchmark* & industry average

(%)	B'mark	Ind. Ave	Investec			CDCM		
			Actual	v b'mark	v ave	Actual	v b'mark	v ave
2007/08								
Jun	1.36	1.16	1.23	-0.13	0.07	1.32	-0.04	0.16
Sep	1.47	1.55	1.56	0.09	0.01	1.33	-0.14	-0.22
Dec	1.43	1.65	1.66	0.23	0.01	1.34	-0.09	-0.31
Mar	1.34	1.31	1.26	-0.08	-0.05	1.34	0.00	0.03
2008/09								
Jun	1.26	1.12	1.18	-0.08	0.06	1.35	0.09	0.23
Sep	1.26	1.48	1.37	0.11	-0.11	1.37	0.11	-0.11
Dec	0.81	2.71	3.40	2.59	0.69	1.40	0.59	-1.31
Mar	0.23	1.03	1.15	0.92	0.12	1.38	1.15	0.35

Investec

Investec was top performing manager by a wide margin in 2008/09. Its cumulative return for the year amounted to a very creditable 7.27%, compared with 3.60% for the benchmark and 6.48% for the industry average.

While a small amount of enhanced return was the result of generally successful tactical trading opportunities in the gilt-edged market, the bulk of it was the result of its activity in the CD market.

Here, it concentrated a good deal of its purchases at the longer end of the maturity range (around 1-year) when yields broke above 6%, a level it considered to be too high given the economic and financial backdrop.

Its view proved correct and the long-dated CD holdings delivered consistently superior yields and some capital appreciation. This latter factor will prove temporary and will erode as CD issues approach maturity. But returns will still exceed what is now available on term deposits with good quality counterparties by a comfortable margin.

The return for the final quarter of the year came in at 1.15% net. There were few opportunities to boost returns by taking an adventurous approach to the markets and as a result Investec chose to maintain a cautious stance. The manager's return compares with a benchmark return of 0.23% and 1.03% for the industry average.

Returns from existing holdings of high yield CDs will continue to boost performance in the near term. But this cannot be expected to continue and as these are replaced by holdings of lower yielding instruments, the income from the fund will decline.

Cumulative performances against benchmark & industry average

(%)	Benchmark+		Ind	Investec			CDCM		
	(a)	(b)	Ave	Actual	v b'mark	v ave	Actual	v b'mark	v ave
2007/08									
Jun	1.36	1.36	1.16	1.23	-0.13	0.07	1.32	-0.04	0.16
Sep	2.83	2.85	2.73	2.82	-0.03	0.09	2.65	-0.18	-0.08
Dec	4.26	4.32	4.42	4.52	0.20	0.10	3.99	-0.27	-0.43
Mar	5.60	5.72	5.79	5.83	0.11	0.04	5.33	-0.27	-0.46
2008/09									
Jun	1.26	1.26	1.12	1.18	-0.08	0.06	1.35	0.09	0.23
Sep	2.52	2.54	2.62	2.56	0.02	-0.06	2.72	0.20	0.10
Dec	3.33	3.37	5.40	6.05	2.68	0.65	4.12	0.79	-1.28
Mar	3.57	3.60	6.48	7.27	3.67	0.79	5.51	1.94	-0.97

* 7 day LIBID: + Benchmark (a) is non-compounded and used as performance gauge for CDCM, (b) is compounded and used for Investec.

CDCM

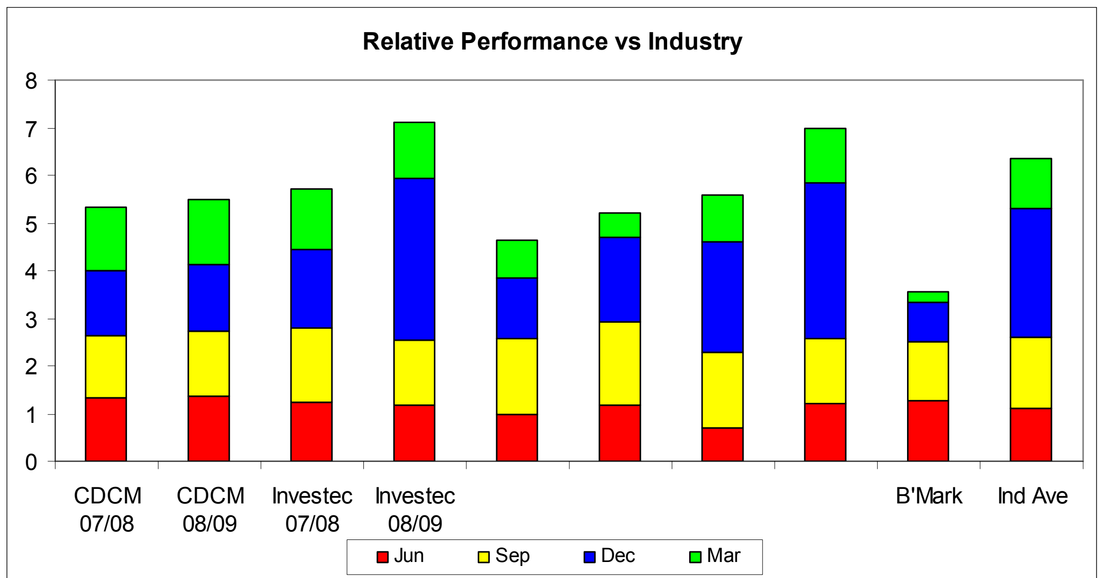
CDCM's performance was also very satisfactory over the quarter and the year as a whole, both in absolute terms and relative to the Council's chosen benchmark. Money markets responded to the official relaxation in domestic monetary policy and the easing in liquidity conditions as the worst effects of the credit crunch dissipate. But the fund has benefited from the effects of previous long-term commitments to deposits at considerably higher interest rates and this is reflected in the results.

Over the quarter, CDCM delivered a gross return of 1.38% against 0.23% for the benchmark. Indeed, the altered circumstances in the financial markets, notably the decline in yields on marketable securities, meant that its return relative to wider range managers moved to a more positive position. The industry average for the quarter stood at around 1.07% gross of fees.

Over the year as a whole, CDCM's total return amounted to 5.51% gross, against 3.57% for the benchmark and 6.48% for the industry average.

The outlook for the next two years does not look as encouraging. The decline in the general level of interest rates, and the fact that they are likely to remain at historically low levels for some time to come, means that investments that replace maturing deposits will generate lower yields.

Nevertheless, returns relative to benchmark should remain satisfactory and if the manager's views on rates are correct (i.e. that they will have returned to a rising path by 2010) the worst of the dip in the market that has and will continue to afflict in-house management might well be avoided.


Relative Performance vs Industry
8
7
6
5
4
3
2
1
0
CDCM 07/08
CDCM 08/09
Investec 07/08
Investec 08/09
B'Mark
Ind Ave
Jun
Sep
Dec
Mar

Performance Benchmarks

Cumulative performances – 2007/08 Financial Year

	Apr - Jun	Jul - Sep	Oct - Dec	Jan - Mar
Benchmark	1.36	2.85	4.32	5.72
Industry Average	1.16	2.73	4.42	5.79
High	1.41	2.91	4.69	6.09
Low	1.02	2.52	4.04	5.44
Upper Quartile	1.22	2.83	4.52	5.89
Lower Quartile	1.08	2.53	4.10	5.70
Median	1.18	2.65	4.38	5.81
Investec	*1.23*	*2.82*	*4.52*	*5.83*
CDCM	*1.32*	*2.65*	*3.99*	*5.33*

Comparative performances – quarterly results 2008/09

	Apr - Jun	Jul – Sep	Oct - Dec	Jan - Mar
Benchmark	1.26	1.26	0.81	0.23
Industry Average	1.12	1.48	2.71	1.03
High	1.21	1.74	3.25	1.16
Low	0.71	1.37	1.27	0.53
Upper Quartile	1.18	1.64	2.53	1.04
Lower Quartile	0.91	1.54	1.65	0.73
Median	1.07	1.60	2.04	0.90
Investec	*1.18*	*1.37*	*3.40*	*1.15*
CDCM	*1.35*	*1.37*	*1.40*	*1.38*

Cumulative performances – 2008/09 Financial Year

	Apr - Jun	Jul – Sep	Oct - Dec	Jan - Mar
Benchmark	1.26	2.54	3.37	3.60
Industry Average	1.12	2.62	5.40	6.48
High	1.21	2.93	5.93	7.16
Low	0.71	2.33	3.88	4.70
Upper Quartile	1.18	2.68	5.05	6.08
Lower Quartile	0.91	2.51	4.48	5.16
Median	1.07	2.59	4.72	5.52
Investec	*1.18*	*2.56*	*6.05*	*7.27*
CDCM	*1.35*	*2.72*	*4.12*	*5.51*