

PENSIONS COMMITTEE – 22 SEPTEMBER 2006

PRIVATE EQUITY AND HEDGE FUND MANAGERS

SUMMARY

Representatives from the Council's new private equity and hedge fund managers will be introducing themselves and their companies to Members at this meeting.

This report provides some background information on their appointment and on private equity and hedge fund investments.

REPORTED FOR INFORMATION

1. Introduction

At the November 2005 meeting of the Committee the results of the asset liability study were reported. Members agreed a new asset allocation which included 2.5% percent allocations to new investments in each of a fund of private equity funds and a fund of hedge funds. A Manager Appointment Sub-Committee was set up to select managers for the new asset classes from a short list drawn up by officers. As a result Partners Group were selected as manager for private equity funds and RMF Investment Management for hedge fund investments.

This meeting provides Members with the opportunity to meet and question representatives of these new managers. Each manager will be making a short presentation on their firm and the investments they are making for the fund. It is hoped to circulate paper copies of the presentations to Members prior to the meeting.

2. Private Equity

Partners Group (UK) Ltd were appointed as fund of funds private equity investment manager. The UK firm is part of the Swiss parent company Partners Group.

The presentation will be made by Mr Stefan Naef (Principal) and his colleague Guy Waller.

The Fund is investing in the "Partners Group Global Value 2006, L.P." which is targeted at a good spread of investments over Europe, USA and Asia and over different stages and type of investment. The detailed legal documentation was signed in July. The fund has entered into a commitment amount of €20m (around £13.6m) in order to achieve an eventual cash investment of 2.5% of the fund. So far Partners have drawn down two tranches of funds totalling £3.5m.

Private equity is capital available for investment in unlisted companies, and can be categorised into :-

- Buy-outs/buy-ins of established companies
- Development capital to enable companies to expand

- Venture capital to start or grow a company from an early stage

Investments are of a long term nature and losses are generally expected in the first few years of investment as there are risks that the companies do not succeed. However there is greater return potential in later years – Mercer assumed a long term return of 11% compared to 8.4% from normal equity investment. In order to reduce risk of losses occurring a “fund of funds” approach has been adopted, whereby a share is taken in many funds. This has the advantage of:-

- Low minimum investments
- Diversification
- Access to top tier managers
- Experience and expertise in selecting funds

The main characteristics of private equity investments are:-

- The manager will seek to obtain exposure to a range of different investments and will call on the investors for money to back these investments over a period of years. In the early years investors are called on for money. In later years the money is paid back to investors as investments are realised.
- To compensate for the illiquidity and increased risk of company failure inherent in such investments, investors will expect a return in excess of that provided by conventional equity markets.
- Exposure to the asset class is typically through a closed end limited partnership pooled vehicle in which a fund's assets are held with other investors.
- J-curve returns expected. That is, the investment will lose value in the early years as cash is invested and fees incurred (this will impact on fund values and funding levels). The true return will not be known until the end of the investment's lifetime.

3. Hedge funds

The contract for investment management in hedge funds is with Man Investments Ltd, a UK company regulated by the Financial Services Authority. The funds will be invested in "RMF Four Seasons Strategies" a fund run by RMF Investment Strategies Ltd, which is also a Swiss company, but is in turn part of the Man Group plc a FTSE 100 company. This investment covers a wide spread of the different types of hedge fund investment in order to minimise risk.

Legal documentation was completed in August, and an investment of £10m made with effect from 1 September.

The presentation will be made by John Wilkinson (Man Investments Ltd) and John Angell (Senior Portfolio Manager at RMF).

Hedge funds cover a broad spectrum, but are essentially funds invested with managers with the aim of achieving a return above cash, rather than relative to equity or bond markets. They aim to add value in all market conditions and may use the four main asset classes of equities, bonds, currencies and commodities to do

this. As such they are regarded as a lower risk investment than equities, and an average annual return of 7% is expected.

The main characteristics of hedge fund investments are:-

- Highly dependent upon manager skill.
- They are typically distinguished from traditional investments by their ability to short sell assets. Short-selling is done through a variety of methods, but essentially means taking a negative exposure to an asset i.e. the fund benefits from a fall in the price of the short asset..
- The term 'hedge' can sometimes be a misnomer, as some hedge funds are fully hedged against market movements (called 'market neutral'), some are partially hedged and some are not hedged at all.
- Often more illiquid than traditional asset classes.

There are a wide range of strategies available, ranging from "Global Macro" (exploiting major economic themes), "Arbitrage" (taking advantage of pricing anomalies), "Event-driven" (taking advantage of pending corporate activity), through to "Long/Short" and "Market Neutral" strategies.

Investing via a fund of hedge funds, allows access to a portfolio of investments:

- diversified by manager and strategy,
- with manager selection, due diligence and portfolio construction delegated to professionals,
- with access to the best hedge funds, many of which have capacity constraints, and
- with typically greater liquidity than individual single strategy hedge funds.

4. Summary of Financial Implications

Investment managers' fees are met by the Pension Fund.

Local Government Act 1972 – section 100d List of background documents

Bexley London Borough Pension Fund – Investment Strategy Review –
Mercer Investment Consulting - November 2005.

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