Hewitt Associates Limited
40 Queen Square
Bristol BS1 4QP
Tel +44 (0) 117 941 6200 Fax +44 (0) 117 929 8060
www.hewitt.com/uk

Powys County Council Pension Fund

Date: 18 February 2010

Prepared for: The Investment Committee (IC) of the Powys County Council Pension Fund

Prepared by: Sion Cole FIA
Rachel Hammond

MTAA Update

Introduction

This paper provides a summary of the Medium Term Asset Allocation (MTAA) opportunities that have been implemented since inception on 3 August 2009.

Summary of decisions

At the Investment Committee (IC) meeting on 21 May 2009, the IC decided that they would like us to commence a 2 year Medium Term Asset Allocation (MTAA) project. This MTAA project would relate purely to the assets invested in equities and bonds with the other asset classes being excluded from the project.

Stage Two of the project commenced 1 January 2010. This means that we are now using a new benchmark of 50% equity / 50% bonds (rather than the Stage One benchmark of 45% equity / 55% bonds).

The following transitions have been carried out so far:

Date	Sell decision	Purchase decision
2 September 2009	Aquila Life Over 5 years Index-Linked Gilts Fund: £5m	Sterling Liquidity Fund: £5m
20 October 2009	World ex-Euro Government Bond Fund: £6m Aquila Life Over 5 years Index-Linked Gilts Fund: £3m	Sterling Liquidity Fund: £9m
15 December 2009	Sterling Liquidity Fund: £6.1m	UK Equity Fund: £6.1m
1 February 2010	Segregated Index-Linked Gilts Fund: £2.56m UK Corporate Bond fund: £2.56m Sterling Liquidity Fund: £2.56m	UK Equity Fund: £5.12m Japanese Equity Fund: £2.56m

We have set out the rationale for each of these transitions in the appendix.

Current position

The following table sets out the Fund's allocation positions since 31 December 2009.

Date	Allocation	Total Portfolio Target	Relative Position
EQUITIES			
31 December 2009	41.5%	45.0%	-3.5%
31 January 2010	43.0%	50.0%	-7.0%
12 February 2010 (estimated)	43.4%	50.0%	-6.6%
BONDS			
31 December 2009	39.8%	40.0%	-0.2%
31 January 2010	39.3%	35.0%	4.3%
12 February 2010 (estimated)	38.9%	35.0%	3.9%

Current position and outlook

Our asset allocation team remain focused on the dual objectives of:

a) raising your equity allocation and lowering your bond allocation, while
b) using our medium-term asset allocation views to add value from the portfolio direction and the equity/bond portfolio choices made.

We have utilised the recent significant dip in the markets in the second half of January to add to equity positions and reduce bond positions further. We will continue to add to equities to reduce the underweight relative to your new benchmark as buying opportunities present themselves during the course of this year.

Our view on equities remains that there are strong headwinds for further gains this year and the renewed onset of higher volatility should present some buying opportunities. Consequently, we are comfortable with an underweight position for the time being, though we are keeping a close watch on the size of the negative equity position from the viewpoint of portfolio risk management considerations. We have also looked to orient the equity portfolio in the direction we consider to be the most appropriate regional mix, reducing the previous underweight position in the UK and moving towards a small overweight position in the Japanese equity market.

Looking to the fixed income side, we have made some recent sales of index-linked gilts and corporate bonds, both of which look likely to have a more challenging year. Index-linked gilt yields have already climbed significantly since our autumn 2009 and early 2010 sales and corporate bond returns have also been under pressure recently from upward pressure on gilt yields.

As we do not expect strong performance from bonds this year, our policy will be to reduce bond exposure on market strength. However, our more negative stance is on government bonds in comparison to corporate bonds, and the current MTAA portfolio reflects this. It may be the case that bond sales will not exactly coincide, and our objective is to use the cash position to ensure that bond sales and equity purchases do not have to come together. This will ensure that we can take maximum advantage of market opportunities in either equities or bonds.

As agreed, a performance-related fee is to be applied from 1 January 2010. The performance-related fee is calculated as 20% of the increase in the monetary value resulting from the MTAA allocations. This would only apply if our recommendations have added more than £10,000 over the two year period to the return of the Fund. We will provide the Committee with fund and benchmark performance figures on an annual basis. The Committee will be able to scrutinise how these figures have been calculated. This will enable full transparency of the performance fee calculation.

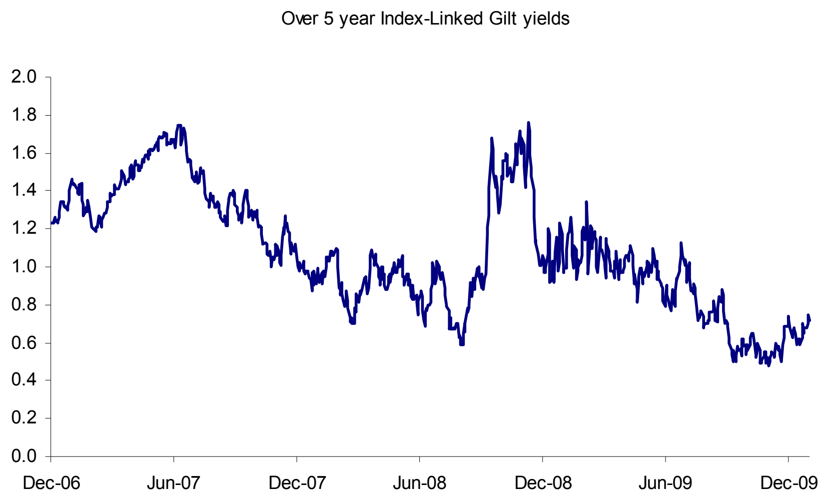
Appendix – Rationale behind transitions

2 September 2009

On 2 September 2009, £5m was transferred from the Aquila Life Over 5 years Index-Linked Gilts fund to the BGI Sterling Liquidity fund.

Our research showed that index-linked yields had reached very low levels - the lowest they had been for 5 years. At these levels, they had become quite unattractive. Our view is that index-linked real yields should be in a range of 1-1.5%. We therefore thought that this was an opportune time to reduce this exposure.

The intention was that this and forthcoming bond allocation reductions should be used to fund an increase in the equity component, but the strength of the equity market rally in the weeks prior to the trade suggested that better buying opportunities were yet to come. We therefore recommended that the proceeds of the index-linked gilt sales were held in cash.



Since this trade, the Over 5 years Index-Linked Gilts yields fell further and then started to rise again during December. It's important for the Committee members to remember that the rationale for these switches is based on medium term and not short term convictions.

---

20 October 2009

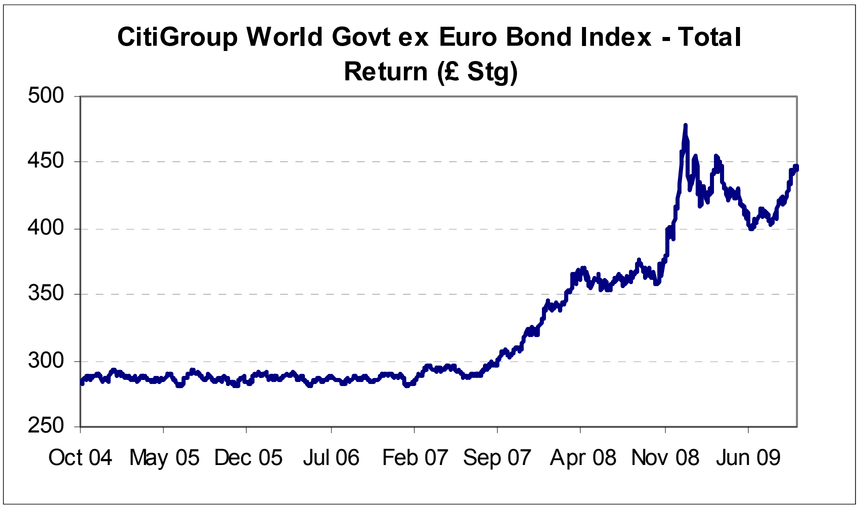
On 20 October 2009, £6m was transferred from the World ex-Euro Government Bond Fund and £3m from the Aquila Life Over 5 years Index-Linked Gilts Fund into the Sterling Liquidity fund, with the intention of purchasing equities when the time was right.

Government bond sale

Our research showed that government bond yields everywhere were still at very low levels, reflecting a view that central banks would keep interest rates low. However, at these levels, yields became even more unattractive on our valuations. We calculated fair values for government bond yields by taking into account fair value real yields, expected inflation, and a risk premium (to allow for inflation uncertainty). Yields as at 20 October 2009, depending on the market in question, were considerably under our estimate of fair values. We anticipated that these yields were more likely to rise than fall over the medium-term.

The portfolio was overweight to government bonds, with a relatively large overweight position in the World ex. Europe fund. These bonds had performed well for the portfolio, and so by selling, the Fund was effectively locking in the good return. The performance of this bond index is shown by the graph below. Since the switch the performance has been relatively flat.

We recommended that the proceeds were held in cash, pending equity purchases at a more opportune time.



Index Linked Bond sale

Our view on index linked bonds had not changed since the previous switch. The yields on these bonds reached very low levels and were infact the lowest they had been since issuance began in the early 1980s. As our estimate of fair value was 1 – 1.5% an opportunity existed to sell a proportion of the overweight allocation and transfer the proceeds to cash, pending equity purchases at a more opportune time.

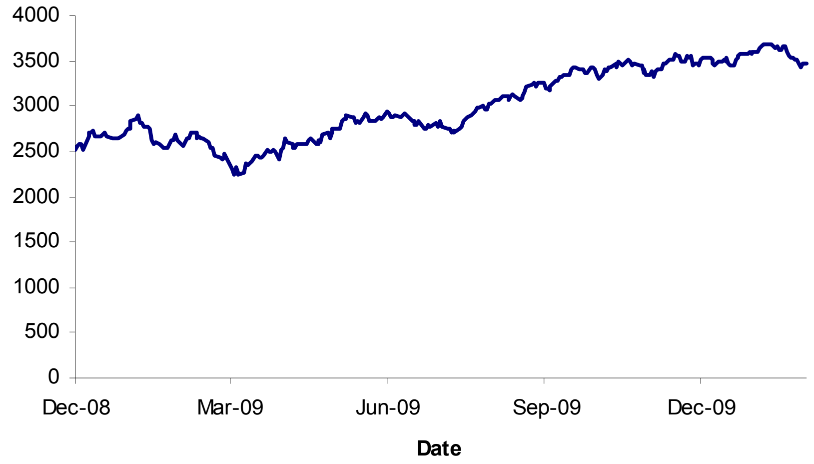
---

15 December 2009

On 15 December 2009, £6.1m was transferred from the Sterling Liquidity Fund into UK Equities with BlackRock.

The Fund was 6.5% underweight to equities compared to the target allocation, and the majority of this came from an underweight position in UK equities. Adding to the UK redressed the imbalance in terms of the existing position on the UK versus other markets. We believed the large underweight position to UK equities in the portfolio was now too large considering the current attractiveness of different markets. Essentially, the UK was at no valuation disadvantage, and on some measures the UK was more attractively valued. Using our favoured measure, the equity risk premium, the UK position was not unattractive enough to suggest that the underweight to equities should be so heavily tilted to this market. As can be seen from the graph below, the index rose slightly after the trade and has also dropped by roughly the same amount.

FTSE All Share return



In terms of our overall approach to the equity markets since we took on the MTAA work in August, our stance was that after the 40% plus rise in the market between March and August, we believed it was inappropriate to add to allocations and preferred to wait for a better buying opportunity. Any buying opportunities that had arisen since had been very fleeting. A tailing off in market momentum made the timing of this purchase reasonable.

---

1 February 2010

On 1 February 2010, £2.56M was transferred away from each of the Segregated Index-Linked Gilts fund, the UK Corporate Bond fund and the Sterling Liquidity First Fund. From the proceeds, £5.12m was transferred into UK Equities, and £2.56m into Japanese Equities.

Equity purchases

We wanted to take advantage of the renewed weakness in equity markets to scale back the underweight equity position that had increased recently on account of the higher equity weights in the strategic benchmark this year. The UK addition was a topping up of the positions made in December, when we noted that the UK was at no valuation disadvantage to other markets to merit a large underweight position. This rationale still applied given the increased underweight as a result of the benchmark change, though the market had outperformed marginally year to date.

We also wanted to use the setback in the Japanese market to move our allocation to a small overweight. We believed that the room for positive surprises had increased given the move to a more stimulatory monetary policy and more determined measures to tackle weak corporate governance. Japan also had a particularly low price to book value ratio compared to other developed markets. This, coupled with the recent slide in the market, presented an opportunity to raise the position in the portfolio.

Bond sales

We also wanted to use the improved tone in the bond markets to rebalance the portfolio away from its overweight bond allocation. We expected the rise in global risk aversion to lead to a period where credit spreads over gilts could widen, and so this was an opportune time to scale the overweight position down.

Index-linked gilts were an overweight position in the portfolio, and were exposed from two vantage points. First, we expect this year to be a rising yield environment as quantitative easing is withdrawn. This applies as much to fixed as to index-linked gilts. In addition, the near-term weakening of market confidence may lead to less demand for inflation protection, raising index-linked yields, currently still close to the lowest levels seen since the establishment of this market in the early 1980s.