LONDON BOROUGH OF TOWER HAMLETS PENSION FUND

REPORT TO

30 SEPTEMBER 2014

Alex Lennard	**Ian Rees**	**Tania McGhee**
Investment Director	**Investment Associate**	**Investment Assistant**
Tel +44 (0)20 7963 8103	Tel +44 (0)20 7963 8052	Tel +44 (0)20 7963 8057
alennard@ruffer.co.uk	*irees@ruffer.co.uk*	*tmcghee@ruffer.co.uk*

PERIOD UNDER REVIEW 30 JUNE 2014 – 30 SEPTEMBER 2014

Portfolio value	**£46,342,381**

Performance (net of fees) to 30 September	**%**
3 months	**+2.4**
12 months	**+3.1**
Since inception (28 February 2011)	**+15.8**

Summary

The portfolio had a good quarter, as we benefited from a turnaround in the US dollar that more than reversed its losses from earlier this year, and from further gains from our long-dated index-linked bonds, especially in the UK. Supporting roles worthy of mention were also played by Japanese equities and key individual stock selections such as Microsoft, Lockheed Martin and ITV. This performance was set against a mixed background for risk assets as equity markets ran out of steam and commodity prices fell sharply, meanwhile bond yields hit new lows reflecting continued growth concerns, especially in the eurozone.

This improvement in portfolio performance was somewhat overdue and brings the portfolio back into positive territory for the year. In the first half of 2014 our performance suffered from the cost of protection assets (US dollar and options) and the lack of progress from our largest equity position, namely Japan. Our sense is that these headwinds are now starting to reverse. Meanwhile, we note with increasing concern the behaviour of equity investors chasing up the prices of much-hyped internet stocks and IPOs with seemingly ever-decreasing levels of shareholder governance. We do not claim to have any idea what the internet-savvy generation might call a ‘pig in a poke’ these days, but we are happy to avoid any of these blockbuster new issues on either side of the Atlantic.

Factors that helped performance

US dollar The dollar strengthened against all comers in the third quarter, rewarding our patience in a key protection asset. The key driver for us was sterling falling by 5.2% against the dollar as markets realised that the UK may neither be quite as politically ‘united’ as previously thought nor the only country where interest rates might soon start to crawl off the floor.

UK index-linked bonds Long-dated UK index-linked bonds gained as global growth concerns pushed down bond yields across the board, a move supported by the first official auction of long duration UK index-linked bonds on a negative real yield.

Options Profits were taken in euro/dollar puts as the dollar rose and volatility bounced off its lows.

Lockheed Martin The US defence stock not only had a strong quarter, but has steadily risen by over 90% since our first purchase in early 2013, when the shares fell on fears of US defence cuts due to the ‘debt ceiling’. We saw this as a short-term issue compared to the long-term cash flows generated from its programmes.

Factors that hurt performance

Gold and gold equities Gold fell back as the dollar surged and commodity prices declined.

BP The company faced a declining oil price and a verdict of ‘gross negligence’ in the Macondo oil spill, against which it will now appeal, but its balance sheet is sufficiently strong to withstand these setbacks.

Summary performance attribution

Five largest positive contributions	**%**
US dollar	+1.7
UK index-linked	+1.0
Options	+0.3
Lockheed Martin	+0.2
Microsoft	+0.2

Five largest negative contributions	**%**
Gold and gold equities	-0.5
US Treasury Inflation Protected Securities	-0.3
BP	-0.2
Volkswagen	-0.1
Atmel	-0.1

CURRENT INVESTMENT STRATEGY

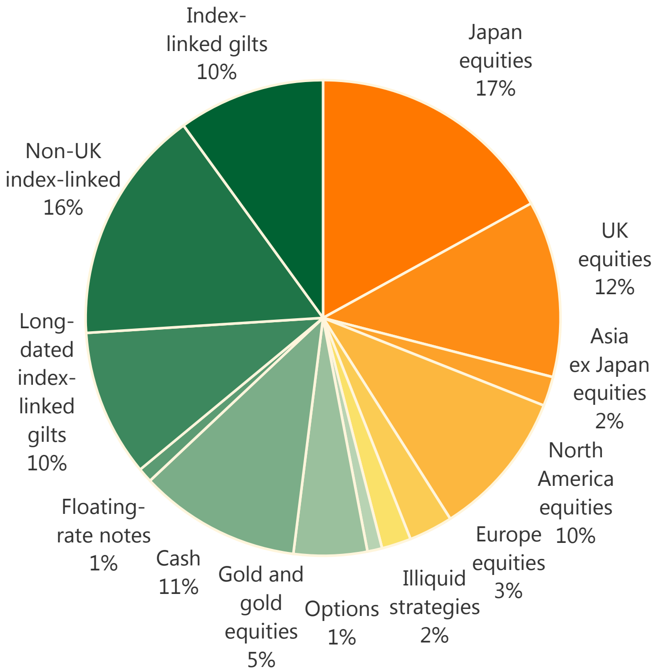
In the enclosed investment review, Jonathan Ruffer re-visits what we are trying to achieve in our investment approach as well as some of the challenges therein. At the centre, he notes, is the desire not to lose money, however the uncertainty of when events occur (particularly risky ones) can leave us looking pedestrian in some stages of the cycle, especially when market trends mature and the consensus view is that it is quasi-permanent. The difficulty of timing is alluded to in the performance summary on the previous page – we have been right about the euro, sterling and dollar this year, but that didn't look the case at the end of April! Unfortunately, timing markets is unlikely to become any easier any time soon.

October is likely to see the end of US quantitative easing ('money printing') and with that markets will shift their focus to when, and at what pace, the Federal Reserve will raise interest rates. Conveniently, the Fed's rate-setting committee publishes the average forecasts of its members to aid markets in managing expectations. Worryingly, the market is currently choosing in part to ignore them – out to 2017 the market is 'behind the curve' suggested by the Fed. The market could well be right, central bankers are clearly in no rush to raise rates, but this does leave it vulnerable to surprise if the hints about higher rates become reality.

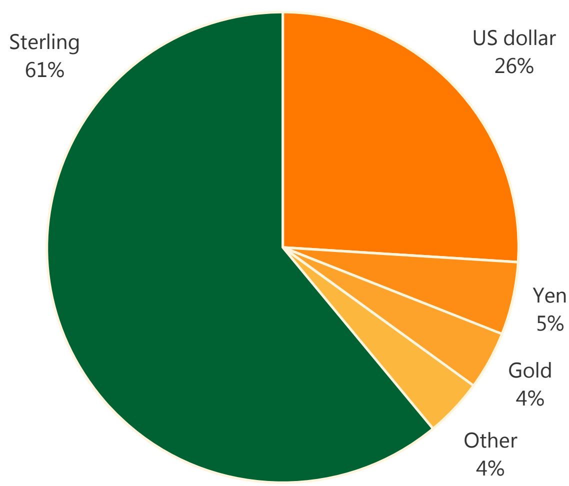
At the same time, our short term worries for the financial system find their expression increasingly in liquidity risk. Financial regulators, fearful as ever of the last crisis, are constraining the ability of banks to provide liquidity across a wide range of assets. This lack of liquidity increases the risk of a disruptive move, whatever its cause, out of higher yield private sector assets into cash or US treasury bills. This worries us; it also worries Janet Yellen, Chair of the Fed, and in July she deliberately described high yield corporate bond valuations as 'stretched'. These bonds subsequently sold off quite sharply, but the observation could apply to bonds and equities generally.

Such observations are worth heeding and we reduced our equity positions accordingly during the quarter to a fraction under 45% of the portfolio. We are also minded to retain our dollar exposure, despite the greenback's recent strength. Firstly to protect against a correlated, perhaps liquidity driven, set-back in both bonds and equities, and secondly, as the first line of defence against a surprise move up in US rate expectations. However, if the future path of interest rates is a source of uncertainty, this is in part due to greater confidence about economic growth, at least in the US, UK and Japan. To capture this we have exposure to banks in all three of these markets along with 'old tech' stocks in the US, such as Microsoft, Texas Instruments and Oracle that combine attractive cash flows with the potential to gain from a pick-up in corporate spending.

Asset allocation



Currency allocation



It is natural that people who run service industries tend to think that they provide a unique service, with the enthusiasts amongst the ranks opting for 'truly unique', and, every now and again, 'extremely unique'. I asked myself that question – are we unique? The question is, of course, absurd – of course we're not! But I have come to the nonplussing answer that we are considerably different from most of our peers.

This review takes a step back from the world's travails and opportunities, and addresses how we set about investing clients' money. There is some virtue in simply getting on with it – no navel-gazing here, please! But regulation forces an answer to the question, 'Is what you do suitable for the client?' For many organisations, who purport to do everything, the answer to the question is to show that the right bran-tub was selected. We parade the fact that we only do one thing – so the answer is binary: what we do is either suitable for a particular client or not. This is why more questions are asked of clients than ever before, both as to their objective requirements and their subjective wishes. It has also made me think through exactly what our investment offering consists of – and this is my answer to that question.

At the centre, is a desire not to lose money. This is disconcerting, since this can be achieved by placing cash in the current account of a bank, and going back to sleep. It has the considerable advantage of avoiding the payment of fees. Why go to the trouble, uncertainty and expense of going to a fund manager whose aspiration is the same as the local bank in the High Street? The answer is that an investment differs from a deposit because it has risk – and risk can either provide a good outcome, or a bad one. The deposit has no upside, beyond the interest it earns – and long-term savings are badly served by such a riskless strategy. However much the marketing departments might wish it otherwise, if you would have the opportunity of a return, you must inevitably take a risk. I have found, over a lifetime of looking after clients, that they love making money, but they hate losing it more. As a slogan, it therefore resonates; the swizz is that not losing money in a portfolio of investments is sometimes impossible to achieve. At Ruffer, we have an added complication: we have been going for twenty years without making a material loss in any single year – the time period over which we judge ourselves. Here is an organisation which appears to say it can walk on water – and, for a couple of decades, it looks like it has! Can I let you in on a secret, dear reader? It's a fluke. It's not a fluke in a directional sense – only in the sense that we haven't failed the test. Sooner or later we will, just as those who aspire to 'outperform the indices' don't do it relentlessly year after year – sometimes they have to point out that aspiration and reality are not the same thing. The correct response to our bedrock desire – not to lose money – and our long-term performance which is remarkably consistent with it, is that we really do have a robust investment process.

The first thing to say is that our aspiration gives us no hiding place, since every investment has the possibility of going down in value, and, even as one buys an investment, it is possible to articulate a number of plausible scenarios which would cause a loss of value. It is frustrating, since it results in the rejection of investments which look to have upside – and which go on subsequently to prove the point – because of worrisome downside. Spreading risk is a crucial element in the exercise – and this means that in a portfolio there will always be something letting the side down, holding back good work done in other parts of the portfolio.

There are two phenomena which aid our way of doing things. The first is that the financial markets are too loosely bound together for everything to be priced efficiently. If the financial world is a casino, then it's one where the roulette wheel is wonky, and some numbers come up more regularly than others, and the croupier is drunk, so calls the odds wrong periodically. The analogy is a good one – juxtapose two opposite 'plays', and if events prove one a loser, causing it to be no worse than dull, and the other is a sparkler, then you escape the tyranny of being ignorant of the future.

The second is that future events are much more knowable than generally conceded – it is their timing which is so opaque that the human mind seems indifferent to the advantages of isolating those things which are very likely to result from today's events. There's an old adage that being right too soon is simply a different way of being wrong – but one can build investments that benefit from future events of uncertain timing into the portfolio, without compromising today's performance. This is not easy, since in the latter stages of a bull market momentum tends to drive down tomorrow's winners, and drive up tomorrow's losers – the period preceding an inflection in the market is a tricky time for our style of investment. It is, however, essential, since tigers don't signal when it's time to stop riding them.

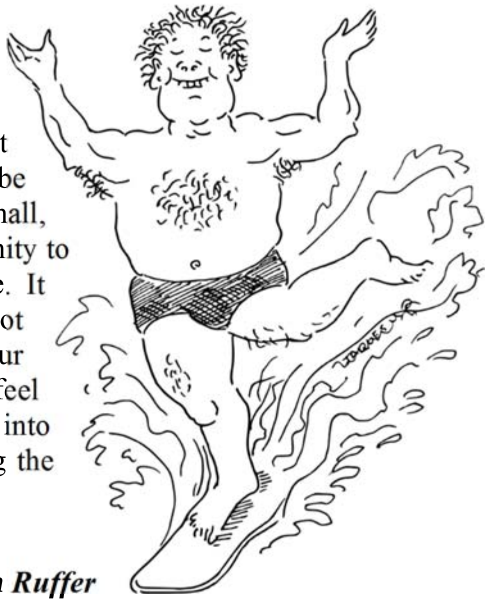
We are therefore looking for asymmetric investments with more chance of a favourable outcome than an unfavourable one. We also need to find investments which cover our backs if a less likely eventuality occurs, but which won't let us down if it doesn't. In research, stockpickers play their part if they find underestimated companies; 'big picture' researchers play theirs by correctly analysing the pressures and opportunities in the world.

It is this big picture 'macro' analysis which helps identify the inflection points (which we have called well during our 20 years of existence), and has helped us in the aftermath of the inflection point. Only when the trend matures, and the consensus view is that it is quasi-permanent, do we slip away from the momentum to embrace the next phase – and in this we will tend to be too soon. This move always appears not so much wrong as perverse – expectations for a continuity are high; it looks like foolishness to have changed direction.

Looking back over the last twenty years, the first five of them were the easiest, and it was during this time that I became aware of the power of this approach to investing. The insight, in 1991, was that the world would go into disinflation, which was regarded with incredulity – but all the new forces in the world pointed that way. China was growing to a size, coupled with the rest of the emerging economies to put wage pressure on the West. Volcker, as Chair of the Fed had put a cap on money supply with eye-wateringly high interest rates. Other countries were adopting Thatcher-like policies which reduced union power, and therefore the possibility of a wages led validation of the inflationary impulse. The rest was easy – invest in blue-chip equities for half the money, and long (preferably irredeemable) fixed interest stocks with the other half: the economic cycle was thereby covered, equities leading the way in the up phase, and the fixed interest stocks in the setbacks.

The distorted price of money – no yield at all, really, on deposits throughout the world – has had two consequences. The first is that it has driven all asset prices up – everything is correlated. The correction is likely to see a similarly widespread fall. The second is more pernicious since the distortion is in riskless money, ie deposits. It means that the safer the investment, the more distorted is its price; there's no safety in a safe investment when it trades at too high a price. All asset classes will fall together, and safe assets will fall by as much as risky assets, because of the distortion.

It is for this reason that we added to our armoury two ways of forcing the odds to our advantage; the first was to favour, from 2009, some illiquid investments, to take advantage of the opportunities thrown up in the rubble of the credit-crunch. Such investments have a timescale not suitable for everybody, so, unusually, we flagged this point to clients to be sure we were doing the right thing. It has been a very satisfactory, if small, element in portfolios. The other is to use options, which are an opportunity to give protection in markets where there is otherwise no hiding-place. It introduces an unwanted element of timing into the portfolios, so we do not commit much money to this, and it may well be the case that our commitments look too timidly small if and when they are needed. We feel that it will be in the aftermath of this shock, when inflation surges back into the world, that the portfolios will feel like those bronzed chaps surfing the Waikiki beach. If only!



Jonathan Ruffer

October 2014

ABOUT RUFFER

Who we are	Ruffer is a privately-owned investment management firm. We currently manage over £17 billion for pension funds, charities, companies and private clients, and employ over 200 people, with offices in London, Edinburgh and Hong Kong. We have a single investment strategy that has followed the same tried and tested investment approach since the firm started in 1994.
Our investment objectives	Our goal is to deliver consistent positive returns, regardless of how the financial markets perform. We define this through two investment aims ▪ not to lose money in any rolling twelve-month period ▪ to generate returns meaningfully ahead of the 'risk-free' alternative of placing money on deposit Since Ruffer started, this approach has produced returns ahead of equity markets, but with much lower volatility and risk. Over shorter time periods, if equity markets are rising, our returns are likely to be lower than those of equity indices, since we will always hold protective assets as well. Although these are our aims there is always the chance that we may lose money because of the nature of the investments involved and it is possible that individual constituents of the portfolio lose all their value.
How we invest	Ruffer portfolios are predominantly invested in conventional assets, such as equities, bonds, commodities and currencies; we also will make use of derivatives. Part or all of your portfolio may be invested in Ruffer in-house funds. At the heart of our investment approach is an asset allocation which always maintains a balance of 'greed' and 'fear' investments. Protective assets, such as bonds, should perform well in a market downturn and defend the portfolio value; those in growth, principally equities, should deliver good returns in favourable market conditions. This blend of offsetting investments reflects the prevailing risks and opportunities that we see in financial markets, rather than any pre-determined allocation. We operate without the constraints of benchmarks that institutional investors have historically been tied to. The asset allocation is fulfilled through specific stock selections. We invest only in companies that reflect the themes we seek to benefit from in portfolios. We never simply invest in a stock market index.
Our investment team	Ruffer's investment team and strategy are led by Jonathan Ruffer (Chairman) and Henry Maxey (Chief Executive). They are supported by a Research Team of over 20 analysts, focussing on economic and market trends, company analysis and developing investment ideas. These are used by portfolio managers on the Fund Management Team to construct portfolios in line with the investment strategy. The average experience of Ruffer's investment team is over 15 years.