London Borough of Tower Hamlets Pension Fund

REPORT TO

31 December 2014

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INVESTORS IN PEOPLE

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PERIOD UNDER REVIEW 30 SEPTEMBER 2014 – 31 DECEMBER 2014

Portfolio value	**£48,290,168**

Performance (net of fees) to 31 December	**%**
3 months	**+4.2**
12 months	**+6.3**
Since inception (28 February 2011)	**+20.7**

Summary

The fourth quarter of 2014 was nothing if not eventful. October's 'flash crash' briefly took equities down 7% from their September highs, while that month also witnessed the end of quantitative easing (QE) in the US, and a surprise expansion of Japanese QE. Elsewhere oil prices, as measured by Brent crude, slumped by 40%, ending the quarter at $57 per barrel, driving the rouble down over 30% against the US dollar. Eurozone risks returned in the form of the failure to elect a new Greek president, meaning an early general election in January, although there was a partial offset as hopes rose of full-blown QE from the ECB. Further afield Chinese equities surged by 37% as the authorities gave extra stimulus to the equity market with rate cuts.

Against this background the portfolio performed very encouragingly, rising by nearly 4%, and taking the gain for the year to just over 6%, a reasonably pleasing outcome given the significant variation in market returns. Our option positions helped us weather October's storm, while the promise of further low inflation readings, via weak commodity prices, caused government nominal and real bond yields to fall. Perhaps slightly paradoxically this produced strong gains in the portfolio's UK index-linked stocks, especially the longer-dated issues. Other helpful developments were further strength in the US dollar and the continued rehabilitation of Japanese equities, which rose by 6% in yen.

Factors that helped performance

UK index-linked bonds Continued low inflation readings, collapsing commodity prices, further Japanese QE and hopes of full-blown eurozone QE all drove global yields lower, thus raising bond prices. The quest for duration drove the 2062 UK index-linked bond up 36% during the year.

US dollar The end of QE from the US Federal Reserve, and a final estimate of 5% annualised GDP growth for the US in Q3 2014 drove the US dollar higher against all major currencies.

China Life Chinese equities rose strongly as investors took heart from the authorities' measures aimed at liberalising financial markets and diverting savings towards financial assets.

Factors that hurt performance

Gold and gold equities The gold price was adversely impacted both by the sell-off in commodities and the rise in the US dollar.

Oil and gas equities With the oil price slumping 40% in US dollar terms the portfolio's small positions in oil and gas equities had a negative impact.

Summary performance attribution

Five largest positive contributions	**%**
UK index-linked bonds	+1.7
US dollar	+1.1
China Life Insurance	+0.3
Oracle	+0.2
Texas Instruments	+0.1

Five largest negative contributions	**%**
Gold and gold equities	-0.3
Options	-0.1
BP	-0.1
Canadian Natural Resources	-0.1
Qualcomm	-0.1

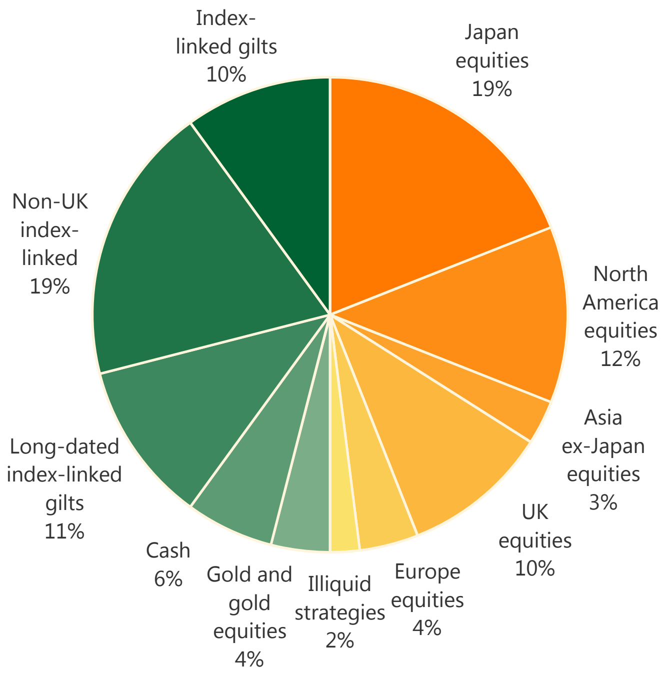
CURRENT INVESTMENT STRATEGY

As Jonathan Ruffer explains in his investment review below, the world's central banks have reached a crossroads in terms of policy. Despite six years of rock-bottom interest rates, and large-scale 'money printing' via quantitative easing (QE), the world's economies have not reached escape velocity. In the erstwhile language of British Rail, RIP, the authorities have created the wrong sort of money, 'voucher money,' exchangeable and usable by financial institutions but not available for spending by the general public. In the desperate desire for growth such extraordinary measures might become even more extraordinary, with fiscal stimulation in the form of tax cuts or government spending. We thus remain utterly convinced of the need to retain our inflation-linked bonds, despite their egregious valuations and recent very strong gains.

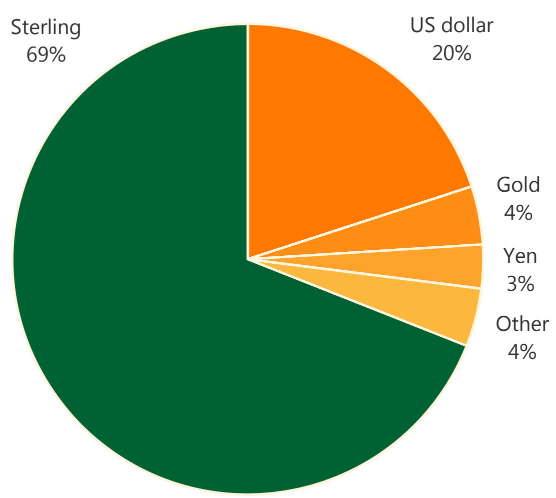
Some might argue that the asset allocation of our portfolios has recently exhibited few significant changes. First off we find succour in inverting Keynes's observation, namely that the facts have not changed sufficiently for us to change our minds. We have dealt above with the need to retain inflation protection. Elsewhere Japan remains our most favoured equity market, a belief spurred on by the expansion of Japan's QE programme announced at the end of October, Prime Minister Abe's convincing victory in the snap election of December, and enhanced competitiveness via the falling yen. There have nonetheless been other changes. We took some profits on our US dollar exposure in November, but have retained a position of around 20%; while the US currency risks becoming a crowded trade, we feel this position might give us two ways to benefit, either from safe haven demand, or stronger relative US growth. During the quarter we added to Chinese equities and purchased eBay, a further representative of 'old technology'.

Lest this seem too pat, clear and present risks abound. The investment review highlights the benign economic effects of the collapsing oil price; it equally points out the malign financial risks in terms of the exposure of high yield debt markets to the energy sector. In this and other contexts the US Federal Reserve has recently been voicing concerns over the risk of dislocation from a lack of liquidity in certain pockets of the financial system. Elsewhere this month's Greek election has the potential to set up another high stakes arm-wrestling contest between eurozone creditors and debtors. Combined with an equity bull market now almost six years old, these factors emphasise the need to keep our primary aim of capital preservation firmly in view.

Asset allocation



Currency allocation



INVESTMENT REVIEW

The last year has been interesting in a number of ways. We have seen, at uncomfortably close hand, two of the Four Horsemen of the Apocalypse. The outbreak of Ebola has reminded us that disease has been a greater killer than war: (my 1912 manual of military hygiene tells me that in the 1895 Madagascar campaign, 5,600 people died from disease, as against seven killed in action). The Ukraine shows that Putin's style of leadership has a long pedigree. Plucky North Korea illustrates the 'woodlouse which bites' phenomenon – objects of fun which need to be taken seriously. Our prediction for 2015? Don't hold your breath for a film called 'The Interview II'. The horse named 'famine' was held at bay this year – commodity prices slumped.

Commodity prices illustrated the relentless power of the deflationary conditions which are as strong as ever – and which, indeed, have gathered strength in 2014. There is now an articulated fear that the inflation rate, which has been dropping towards the zero level, might go negative, representing real deflation. Those who control monetary policy around the world are genuinely fearful that this deflationary force is unrelenting. Before addressing this interesting question, let me deal with an inevitable question – are we admitting that Ruffer have made a wrong call by predicting a coming inflation, and owning long dated inflation-linked bonds? The second part is best dealt with arithmetically – the longest such bond in the UK is up by 50 per cent in 2014, and the US equivalent (which we also own) is up by around 30 per cent. Both were comfortably ahead of the Portuguese bond market – the 'best' bond market in the world. We also held gold bullion and gold shares to protect the portfolios from deflation – both bad investments, notwithstanding the deflationary conditions. Investment is not as straightforward as it looks!

When the central authorities think of deflation, they think primarily of America in the 1930s, and, less often, of Japan in the 1990s; it is, rather, the 1880s which provide the more authoritative parallel. The years 1873 to 1896 saw consistently falling prices, low profitability, low wages, fullish employment, and a world of opportunity to all; it was the period when Andrew Carnegie became the richest man the world has ever seen – a phenomenon one would intuitively associate with boom conditions. It was a world of white bread for all, of sugar in the workman's tea. Its key feature was 'winner takes all' – in the 1880s, changing technologies saw the Western hemisphere's sugar-refining industry move no less than five times, ending up in Puerto Rico. The earlier iterations were left with almost modern plants, scarcely depreciated – but utterly useless. When the winds of change blow, they can destabilise even the most conservative of business models: a graphic example is food-retailing in the UK. When a hitherto profitable model breaks down, the ramifications are wide; the retailers try to protect themselves by squeezing suppliers – it is estimated that some 30 per cent are underwater, including the whole of the milk producing industry, where prices are running at less than the cost of production. Its mischief stretches out into real estate – who would regard a 25 year upwards only rent on a Tesco warehouse with quite the same benign complacency as in days gone by? Aldi and Lidl may look like giant-killers, but they are entering an arena inherently compromised in terms of overall profitability – the very hallmark of 1880s-style deflation.

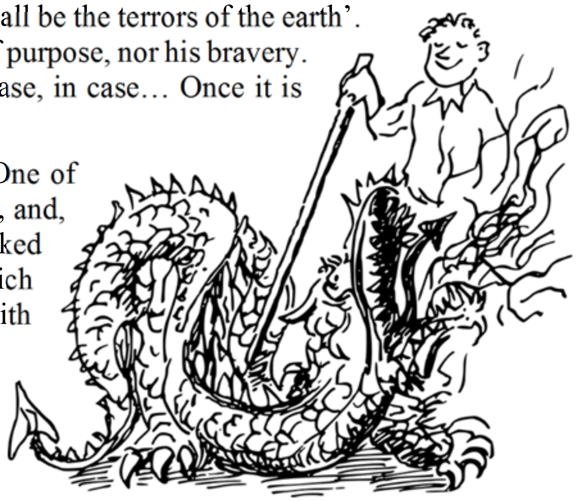
More recently, the world of central-bank economists has made a series of wrong calls – the humiliating thing for them is that it hasn't really mattered. There was an assumption that economies could be declared robust again when unemployment fell; when Mark Carney, the new Governor of the Bank of England, drew his inaugural line in the sand as to when interest rates would rise, the employment figures on which he had hung his cap immediately signalled 'time for a rise'. He wisely retracted his position on this. There were misgivings, though – perhaps interest rates would be held low too long, and inflation would erupt? But no, the inflation rate has continued down. This accounts for the rather odd situation of the fall in the oil price being treated as a solemn warning of deflation – when it was obvious to every cab driver and shoe-shine boy that this was manna from heaven to all except those in the oil industry.

This is the background character of the world in which we live. One last aspect remains to be considered; it explains why the authorities have been seemingly powerless to combat these elemental deflationary forces. It is clear that quantitative easing (QE) is not enough to stop mother nature – and the effect on government balance sheets has been sufficiently damaging to bring this money-creating initiative to a halt. Why hasn't it reversed the primary dynamic, even in Japan, where the target of doubling the money supply, accompanied by a sharp fall in the yen's value, has not worked? The answer in layman's language is that QE did not create fully-effective money, so much as vouchers which were only valid in the financial system. It did a great job in improving the finances of the banking system, but it did not go further than that, because the financial institutions did not remit it further – into the real world of corporations and consumers. It is partly a result of that 'winner take all' dynamic that we have already visited – corporations are not at all sure that they would be the winner in the present climate, so are disinclined to borrow. Bank regulators, ruthlessly pursuing the problems of yesteryear, have reinforced this tendency by making it more expensive for banks to take risks on their balance sheets. In times of stability, this shows itself in subdued borrowing figures; if and when unstable markets appear, there will be an alarming lack of liquidity in the system, since the natural counterparties to frightened sellers are market makers accommodating them, and the banks have curtailed the size of their books. As things stand, no weapons have been fired against this deflation – but these weapons exist, and we believe that they will be used, early in 2015 in Japan. When it is established as effective, it will be used elsewhere – and the inflation we wait for will have arrived.

To repeat, quantitative easing is a voucher, and not money – and, crucially, it is not available to consumers, who alone are capable of expanding the stock of money enough to create a rise in prices. The insight is to see that a drop in taxation has precisely that effect. We have seen that money to banks, coupled with an injunction to pass it on by way of loans does not work – the banks are 'frit'. An increase in spending power through lower taxation is the way to achieve it. (Parenthetically, the drop in the price of oil might just have a similar multiplier, and end up as an inflationary force.) Governments are reluctant to do this, because through their central banks, their balance sheets are already compromised by QE, by having transferred the burden of debt from the financial sector to themselves. Economists have coined a word for extra borrowing without any balancing factor – they call it 'monetising' the debt. It's a pretty uninteresting word, combining sleep inducement and opacity, but it's a dog whistle in such circles for rampant inflation.

We have an almost comical situation; the forces of deflation are seemingly irresistible, there's one solution, which mustn't be used because it would bring about inflation. The author of this review once complimented Sir Geoffrey Howe on his boldness and insight in breaking the inflationary spiral with policies deemed reckless at the time (1979/1980). He laughed and said that everything else had been tried and had failed; it was merely common sense to try it. So it is today. As deflation looms larger, tax cuts increasingly look like common sense. And we believe that Japan is already set on a dramatic course to achieve this, with corporation tax changes linked to wage hikes, and a supplementary budget. There are, of course, the usual moans of 'too little, too late,' but these would continue even if the Abe government posted a bundle of banknotes to every Watanabe in Tokyo. Consider the facts. The country knows what a generation of falling prices does for an economy, and the strains it puts on a society. Shinzo Abe was elected Prime Minister in 2012, and promptly declared war on deflation, promising to double the supply of money in Japan in three years. He is on course to deliver that – the currency has dropped from 75 yen against the dollar, to 120 since then – and yet there is still no inflation: the steps, radical as they were, turned out to be voucher-like in their effect. Government indebtedness is at seemingly impossible levels, at 250 per cent of GDP – but we have reason to believe that they are considering this course of action – providing the soap which will transform the behaviour of the unwashed consumer. Abe called a snap election in December, promising a delay of the consumption tax (VAT) to be introduced next year; he won, effectively unopposed. His radical agenda is treated by the rest of the world as the ravings of Shakespeare's King Lear: 'I will do such things – what they are yet I do not know – but they shall be the terrors of the earth'. He has the mandate. From 2012, we need not doubt his sincerity of purpose, nor his bravery. The rest of the central banks are reluctant to think like this, in case, in case… Once it is seen to work, others will join.

Inflation, deflation are both symptoms of monetary instability. One of the by-products of deflation is that asset-prices are driven higher, and, alas, the opposite is true of inflation – hence our inflation-linked bonds. If this analysis is right, the onset of inflation in Japan, which is a generation ahead of the rest of the world, will be treated with euphoria; the deflation dragon is slain! Time enough to worry about the next mischief! Japan, which missed out in the bull market of the last 25 years, could miss out on at least the initial stages of the next global bear market, which is why we favour that region for our equity exposure.



Jonathan Ruffer
January 2015

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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.