Health Professions Council
Finance and Resources Committee Meeting – 20th November 2006

INVESTMENT POLICY REVIEW - PUBLIC PAPER

Executive Summary and Recommendations

1. Introduction

2. Decision

The Committee is requested approve the continuation of the existing policy, or recommend changes as appropriate.

The Executive have made minor amendments to the existing policy – see the attached revised copy.

3. Background information

The 2005 Baker Tilly review of Management Controls (point 7.3) highlighted the need to update HPC's Investment Policy Guidelines. This update was presented to the Finance and Resources Committee at their 21st November meeting. An action point (Item 10) arising from that meeting was to review the Investments Policy on an annual basis and amend as appropriate.

The Rensburg Sheppards funds managed achieved a quarterly return for the quarter ended 30th September 06 of 3.5% and 11.3% for the 12 mths ending Sept 06. This compares to the WM index (World Markets) return of 3.5% for the quarter and 11.7-12% for the 12 mths ending Sept 06. It's worth highlighting in the HPC fund, 19.5% of the HPC investment funds were in Fixed Income products (lower yields) versus only 12.7% of WM funds in Fixed Income products. Rensburg still charge a flat fee and transaction charges equating to about 0.5% of the funds managed as commission.

Notes

The market value of the investment funds was £1.825M at 30 September 2006. This is up from £1.763M at 30th June 2006.

At 30th Sept, 60.3% of funds were invested in UK Equities, 19.5% in UK Fixed Interest, 6.1% in US Equities, 4.9% in European Equities, 4% in cash and the rest in other Overseas Equities.

Of the UK Equities, by sector, 30% was invested in the Financial sector, 13% in Oil & Gas, 11% in Consumer goods, 10.2% in Utilities, 9% in Industry, 8.6% in Consumer Services, 7.7% in Healthcare, 6.9% in Telecoms, and the rest in Basic Materials.

Of the UK Fixed Interest investments, this covered British Government Stocks (5.5% return), Foreign Bonds (Euro Inv Bank), debentures and unsecured loans and HBOS preference shares.

4. Resource implications

Nil

5. Financial implications
Nil

6. Background papers
Nil

7. Appendices
- Investments Policy (revised)
- Investment Quarterly Report

8. Date of paper
8th November 2006

HEALTH PROFESSIONS COUNCIL (HPC)

INVESTMENT POLICY
(Approved by the Finance and Resources Committee on XXX)

1 INTRODUCTION

HPC commenced operations on 1st April 2002 inheriting the net assets and reserves of the Council for Professions Supplementary to Medicine (CPSM).

The value of the investment portfolio (managed externally) at 1 April 2002 was £2.15M, exclusive of cash balances held for investment.

The 31 August 2006 market valuation of the HPC funds managed by Rensburg Sheppards Investment Management Ltd[1] (RS) totalled £1.6M, after withdrawals of £800k for special project funding since 2002 (LISA and Park House renovations) and a further £250k in May 05 to assist in purchasing Purbrook & Eyres Ltd share capital to acquire the 22-26 Stannary St building space.

2 INVESTMENT POLICY

2.1 **To invest surplus funds in income and capital growth-generating investments, without putting those funds at undue investment risk and without "locking up" the funds when they are needed to run the business i.e. ensure funds aren't locked up for a longer duration than HPC's cash-flow needs, or aren't invested in items that are difficult to convert into their cash equivalents at current market valuation.**

Potential income-generating investments include things like cash term deposits, bonds, equities paying dividends and property, if rental income is obtained from it. Potential capital-growth investments include things like equities (share price increases), real estate (capital value increases), collectibles and bullion such as gold and silver.

Such investment types each have different levels of risk and return, different types of professional expertise required to select, manage and realise the value from them.

2.2 **To utilise a combination of indirect and direct investment methods for investing surplus funds, where appropriate internal control can be maintained, where appropriate external investment expertise can be leveraged and where investment risk can be better diversified or minimised.**

An example of *indirect investment* is outsourcing the investment and management of an investment portfolio (e.g. real estate, shares and bonds) to one or more professional fund management firms. An example of *direct investment* is the Finance Dept instructing a trading bank to place surplus cash in the commercial money market for a fixed term. A second example is

[1] Rensburg Sheppards is an investment management business (fund management firm) with more than £10B client funds under management (www.rensburg.co.uk).

HPC choosing to buy London commercial property (Park House and Stannary St, Kennington) to meet its office space needs.

Indirect investment

Typically done by utilising the professional expertise of external fund managers, to ensure funds transferred to them are invested in a diversified portfolio (a mixture of various shares and fixed income products, in different countries, sectors and institutions within a given sector). Fund managers typically charge an annual management fee to administer the portfolio, typically 1-5% of the fund value per annum, regardless of fund performance.

It is important that where HPC uses one or more external fund managers, that they are of sound commercial standing (solvent and reputable) and that regular fund performance reporting occurs. There are two aspects to this – firstly, regular fund reporting at financial month end, to allow timely market valuation of the fund value in the HPC balance sheet. And secondly, at least quarterly sector-benchmarking on fund performance (fund % returns considering both capital and income gains, less fees charged to administer those funds).

Where funds are provided to an external firm of fund managers, they may at times “cash up” some of the equities or bonds and invest in the Money Markey in the short term, to position themselves for purchasing further shares or bonds at cheaper prices. Unless they retain the freedom to act tactically, their ability to generate fund returns that are attractive to HPC will be diminished.

Investment risk minimisation through diversification

Investment risk and return in global capital markets with fast information flows (about price and risk changes) are inherently linked. Some types of investment risk can be minimised by diversification - essentially “not putting all your eggs in one basket”. Some risk diversification can be achieved by investing in different, unlinked investment types (property, fixed income, equities) and by diversification within a given investment type e.g. where the fund manager buys shares in a range of companies.

However, within an investment type such as equities, some risk cannot be eliminated no matter how many share types are invested in. For example, the risk that the share market as a whole might suddenly crash is difficult to avoid, other than by buying hedging instruments (the value of which increases as the market value of the underlying products reduce) or avoiding investment in those markets entirely.

Inter-relationships

Investment returns and risk need to be assessed in relation to the HPC Reserves policy and Five Year Plan for assumed fee changes i.e. the three are inter-connected. To elaborate, in the medium term, if fees are not able to rise to offset cost increases, but ongoing compliance with the agreed Reserves policy is maintained, then investment returns need to rise. However, higher investment returns will typically involve incurring increased investment risk (more value volatility and/or greater potential for losses).

Short term money market investments

As well as the approx £1.6 M investment portfolio managed by RS, cash funds (typically £1-2M) are invested directly in the short term in income-generating money market deposits and a Business Reserve account. Indicative annual interest rates on these at the time of writing are 4.6% and 2.5% respectively.

Corporate Bonds versus the Money Market

At the time of writing, Nat West Corporate Bonds could only be invested for a minimum term of three months, while equivalent-yield money market investments could be made for a minimum of one week. Given the lack of an HPC overdraft facility and cash-flow forecasting uncertainty, then as a precaution, surplus cash is being invested in the money market for one to three week terms at the time of writing.

Credit Rating of Financial Institutions for Direct Investments

2.3 **Our policy is to directly invest cash reserves in products offered by financial institutions with a Standard and Poor's Credit Rating of at least AA minus (Moody's Credit Rating of AA2) and where the interest rates are market-competitive.** For example, Nat West bank where money market investments are held at the time of writing, have this rating.

We have a procedure of obtaining three rate quotes from financial institutions with at least the above credit rating, to ensure rates received are market-competitive.

3 ETHICAL POLICY

Because HPC is a health regulator, the investment portfolio fund managers have been requested not to invest in companies trading in tobacco products.

4 FEES

Because of the relatively small size of funds placed indirectly, HPC has limited ability to negotiate fees outside the standard terms. RS fund managers are remunerated purely by commissions on transactions. At the time of writing, RS have confirmed a commission basis of 0.5% of the funds managed. This is a £8k annual fee for managing £1.6M investment portfolio funds.

5 BENCHMARKING

Notwithstanding the fund management sector performance indicators outlined in the quarterly valuations provided by RS, HPC reserves the right to undertake a review of the performance of the portfolio using other means.

The RS Fund Manager will be invited to attend at least one Finance and Resources Committee meeting per year (more if the Committee requires it so) to provide a summary report on fund performance and address any questions the Committee may have relating to the funds under indirect management.

6 REPORTING

The RS fund managers provide a detailed report to the Finance Department at the end of each month. This forms the basis of the balance sheet valuation of the investments at month end and provides details of all investments in the

portfolio (holdings, additions, disposals). Market Valuations are also sought on a periodic basis, on commercial property investments managed directly by HPC. For details of how commercial property is reported in the HPC balance sheet, please refer to the Notes to the Annual Financial Statements.

Rensburg Sheppards

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Authorised and regulated by the Financial Services Authority
Rensburg Sheppards Investment Management Limited is registered in England
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[illegible]

Our Ref : JM/VM/COUNC0004

13th October 2006

Charlotte Milner
Health Professions Council
Park House
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London
SE11 4BU

Dear Charlotte

Health Professions Council

I am writing to enclose the quarterly report for the period 30th June to 30th September 2006. Over this period the portfolio has shown a net gain of £62,018 to £1,825,218.

On a time weighted total return basis the portfolio has appreciated by 3.7% for the three month period and by 11.3% for the rolling twelve months.

Stock markets have been a good deal more nervous over the last three months, following the sell off in May, extrapolating from each corporate or economic announcement whether growth is too strong (and inflationary) or too weak (and likely to adversely affect corporate earnings.

In reality two of the inflationary forces have moderated, oil prices and raw material prices, and one of the slower growth fears, falling US house prices, have not yet infected the rest of US consumer expenditure.

As a result most markets have made modest gains, although much of this came in the last few days of the quarter. For example on 25th September the UK market was virtually unchanged and cash would have shown a better return than UK equities, but by the close on 29th September, four days later, the UK equity market had gained 3.6% and cash 1.1%. The funds UK equities appreciated by 4.8%.

Oil prices have fallen from a high of US$78 to around US$62 due to oversupply following excessive demand earlier in the year, a cessation of conflict in Lebanon and some dialogue with Iran over its nuclear programme. Also the spectacular failure of the hedge fund Amaranth, losing US$6bn out of US$9bn of assets on gas contracts that went bad is a sign of the level of speculative excess earlier in the year in the commodity markets.

In the US the cost of a gallon of petrol has fallen from around US$3.13 to US$2.57 helping consumer sentiment. (Ours by comparison still costs £4.50 a

Belfast
Cheltenham
Farnham
Glasgow
Leeds
Liverpool
London
Manchester
Reigate
Sheffield

gallon but at least it has fallen by 50p). US producer prices rose by 3.7% year on year in August but this was down from 4.2% in July and was seen as some confirmation of moderating inflationary pressures.

The US consumer is seen as key to maintaining strong global demand and with US house prices falling by 6% year on year there are concerns that the increase in US interest rates to 5.25% may cause a wider slow down.

But in fact the US economy remained relatively firm. New home sales actually rose by 4% in August from a three year low in July (as lenders cut mortgage rates and builders cut prices). Consumer confidence has actually been rising through September albeit from lower levels. Unemployment at 4.7% remains close to the lowest levels since 2001. Inflation (as measured by Federal Reserves preferred measure, the price deflator) was running at 3.2% in August down from 3.4% in July and well below US interest rates.

The US budget deficit has improved substantially and, as oil was one of the major causes for the ballooning of the trade deficit, a fall in the oil price should help counter that previous trend.

In the UK, economic growth is slightly stronger than expected, house prices have recovered from their earlier weakness, and the consumer did not react to the interest rate rise in August. As a result it is widely expected that rates will be increased again in November. One cause for concern is that wages are growing at 3.7% a year (or 4.4% including bonuses) despite the high level of immigration. The government has indicated that it will contain public sector wage growth to 2% and anecdotal evidence suggests that NHS employment advertising has slowed rapidly. But with the political impasse until a successor is found for Tony Blair there may be little resolve to hold the line. This policy vacuum until the middle of next year(?) may also weaken sterling due to the uncertainty.

Rising producer prices, a concern for cost push inflation in the UK, have also moderated. They have still risen by 7.6% year on year but this is down from 10.2% in July and 15.2% in April. Therefore the UK economy whilst not quite perfect nevertheless remains reasonably robust.

UK short dated bonds were little changed over the quarter, due to the inflationary worries, but we have used this relative weakness to add to this area of the market. Long dated bonds continue to be fuelled by pension fund demand which is driven more by a desire to limit balance sheet risk than maximise returns. As a result they have gone from poor value to even poorer value rising by 4.9% (compared to 1.1% for short dated gilts) over the three months and the redemption yield falling to 4.1% compared to 4.8% on short dated gilts and yields of 5.5% to 6.0% on shorter dated corporate bonds. With wage inflation close to the returns on longer dated bonds it is difficult to perceive this as a good way to save.

Continental Europe has again been the best performing geographic sector over the last three months as economic activity remains strong and the consumer has remained confident, but a local currency return of 8.0% was reduced to 5.6% for a sterling investor caused by the slight weakness of the Euro, despite

the two rate rises we have seen during the quarter and the prospect of more to come.

Japan was again the laggard returning -2.3% weighed down by worries about economic recovery, the Presidential election (which culminated in the election of a new Prime Minister Shinzo Abe in the last week of the quarter) and weakness in the yen. But Mr. Abe is expected to continue the improvements seen under Mr Koizumi, unemployment is at its lowest since 1998, consumer confidence is at its highest for 15 years and property prices are starting to rise in Tokyo and Osaka.

We have also been continuing to look for opportunities to add to the Far East where yields on equities are now available and stock markets have been relatively firm buoyed up by the strong savings rates. Also the reaction of a fall of just 5% to a coup in Thailand was taken as a sign that markets are relatively sanguine at the moment. Asia ex-Japan appreciated by 4.1%, but unfortunately discounts to net asset values have widened over the period leading to slight underperformance against indices.

The Far East continues to have large trade surpluses, oil countries likewise and the high raw material prices have helped some of the emerging economies like Mexico, Brazil and some African countries substantially improve their balance of trade positions and repay large amounts of overseas debt.

Consequently we have used the weakness seen over the last few months to reduce the cash balance and add to the equity proportion of the portfolio. Given our concerns about a cyclical slow down we have been reluctant to overly add to cyclical areas of the UK market, preferring to add to stocks with more secure earnings growth like Unilever and Ladbrokes and even biotechnology companies through the Axa Framlington Biotechnology Fund, as valuations are as low as they have been since 1995and prospects are improving.

One exception was the purchase of Barrett Developments a house builder which was standing on a p/e of 8.5x, a discount to a sector which was already lowly rated, because of earlier concerns about weakness in the housing market.

At a sector level, most UK sectors are fairly prices relative to their European or US counterparts, providing few anomalies, but sector rotation has continued often with global influences. The oil and gas and resources sectors fell by 5.2% and 4.3% respectively. Cyclical stock like engineers rose by under 2%, but the aerospace sector recovered by 6.0% on lower oil prices. Construction and building materials stood out with a gain of 16.0%, leisure by15.2% and general retailers by 7.4% as consumer spending remained strong. Pharmaceuticals again lagged falling 1.0%, held back by Glaxo, but other less cyclical sectors like telecoms and utilities performed well with fixed lines (BT) appreciating by 14.3%, mobiles (Vodafone) by 6.4% and utilites by 12.4%. Media continued to be disappointing as advertising revenues remain poor, but within the sector Reuters rallied strongly gaining 12.8%. The banking and insurance sectors rose by 6.1% and 6.4% respectively and still provide good value with the possibility of corporate activity.

We have used the weakness in the commodity stocks to add to both base metals and oil stocks as the share prices were discounting excessive weakness and if, ironically, there is less need for rates to rise much further then this period of global economic expansion can continue and resource prices can remain firm. In particular we have recently added to BHP Billiton the world's largest exploration company whose oil assets are in the North West Shelf and Bass Straight in Australia, the UK and the only area of any potential geopolitical concern is Abu Dhabi. Whereas approximately one third of BP's output comes from it's joint venture in Russia and nearly 60% of Royal Dutch Shells exploration acreage from the Sakhalin project, is also in Russia, leaving them both vulnerable to the potential for Russia to claim a larger share of the output, or worse.

There is an old adage which says "do not fight the Fed" which means do not add to holdings when the US authorities are raising rates. The US have raised rates 17times since 2001 and over this period the valuation of the US equity market had fallen from a p/e of 35x to around 15x giving plenty of scope for improvement now that they have stopped. Corporate balance sheets are very strong and more shares have been retired from Wall Street than issued over the last few years. Profit margins are also at record levels. This is an area we may look to add to further if the current "benign" state continues.

At the moment the glass seems half full again and we are taking the opportunity to add to weightings and take advantage of the low valuations, but it would only take a run up in the oil price or some weak economic numbers to undermine the confidence, so we are trying to manage the stock selection carefully.

With kind regards.

Yours sincerely

James Minett
Senior Investment Director

Encl.