The Highland Council

Nairnshire Committee
7 December 2016

Agenda Item	**7 ii**
Report No	**N/28/16**

Nairn Common Good Fund – Investment Strategy

Report by the Director of Finance

Summary

This paper proposes an investment strategy for the current cash balances held by the Nairn Common Good Fund and outlines the governance around how those investments will be managed.

1. Introduction

1.1 The Nairn Common Good Fund currently has considerable cash reserves which are earning a minimal level of interest. Members have agreed an intention to make a longer term investment, commensurate with their agreed level of risk, to try to grow the overall value of the fund.

2. Investment Management

2.1 It is proposed that Adam and Co., investment managers for the Inverness Common Good Funds (ICGF), are asked to manage this investment for the Nairn Common Good Fund.

2.2 Adam and Co. will be given discretion over the exact details of the investment but any investment will reflect an agreed attitude to risk and return.

2.3 The management fees charged to the fund will reflect those currently charged to the ICGF. Adam and Co currently levies a management fee of 0.4% of the total value of the portfolio. Additional underlying fund fees (Adam and Co. often make investments in funds rather than individual equities) may be payable which will depend on the exact investments made. For the ICGF investments this ranges from 0.25% to 0.79%.

3. Risk

3.1 **Appendix 1** provides Adam and Co.'s 'A Guide to Risk and Return' which highlights a number of different investment risk categories. In very general terms the higher the risk category the higher the potential level of return, albeit that increased risk brings with it the potential for greater volatility in the value of the investment.

3.2 Discussion with Members would suggest that a medium risk category would be appropriate for this investment, in the middle of the 'lower and upper ends' as detailed.

3.3 Whilst past performance is no guide to future performance it should be noted that the three separate ICG funds have an average annual performance of between 11 and 13% for the last 5 year period which is in excess of their benchmark level.

3.4 Members should be aware that this investment should be considered as a long term investment with a suggested minimum five year time horizon as per Appendix 1. Whilst any investment will be relatively liquid, i.e. easily turned into cash, doing so at a specific point in time may realise less than the original investment.

4. Governance

4.1 It is suggested that the performance of the investment is monitored through the Council's investment sub-committee which meets quarterly. This will also allow for monitoring by the Council's officers and external investment advisor Aon Hewitt.

4.2 An appropriate benchmark will be set for the performance of the fund, this will take into account the risk profile chosen.

4.3 It is proposed that an annual update on performance is brought to the Nairnshire Committee at the same time as the annual accounts are provided.

5. Amount to Invest

5.1 The Nairn Common Good Fund's 2015/16 accounts are reported as a separate item on this agenda. It is suggested that £0.4m of the 'revenue funds' reserve is invested with Adam and Co. This investment would allow a small sum to be retained for any immediate works required on the Fund's property assets.

5.2 The fund's annual budget monitoring for 2016/17 is also reported on this agenda. The expected annual surplus generated by the fund could either be used to increase the value of the investment made or used for investment or spend on the fund's other assets.

6. Implications

6.1 Any investment of this nature carries risk as outlined in this report. Members should be reminded that if they wish to liquidate this investment at any point in the future there is no guarantee that the value of the investment at that point will be greater than the initial amount invested.

6.2 There are no known Equalities, Climate Change/Carbon Clever, Legal, Gaelic or Rural Implications.

Recommendation

Members are invited to:-

i. approve an investment of £0.4m to be managed by Adam and Co.; and
ii. confirm that investments are commensurate with a risk category in the middle of the medium risk category.

Designation: Director of Finance
Date: 24 November 2016
Author: Edward Foster, Head of Corporate Finance

A guide to Risk and Return

Discretionary Investment Portfolios

At Adam Investment, we believe that no two individuals have the same attitude towards, or ability to take on risk. Portfolios are constructed to best meet the needs of our clients based on the information that they have provided and their specific investment needs and risk tolerances.

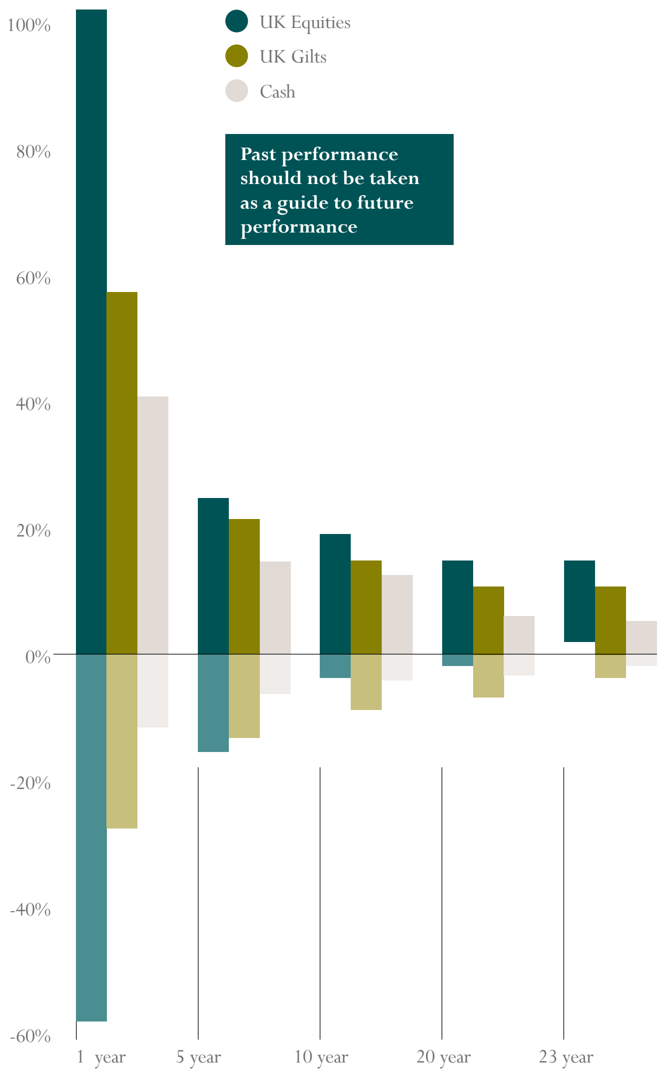
Before investing in a discretionary portfolio it is important that we highlight to clients the nature of risk and return.

This document provides a broad overview of risk and return, looking at the performance of different asset classes over time and how these are balanced to construct portfolios with different risk. It also explains how risk is quantified specifically in relation to Adam Investment portfolios.

Finally, to put this information into context, this document sets out the performance of Adam portfolios over the past ten years.

An overview of risk and return from a long term perspective

The chart below illustrates how different asset classes in the UK have performed on an annualised basis, that is the return earned by an investment over the course of a year, since 1899. The key point to note is that the longer an asset class is held, the lower the overall dispersion between the best and worst outcomes. Over the very long term it is clear that equities have provided the greatest 'hedge', or potential for protection, against inflation. However, what this chart also demonstrates is that equities expose investors to the greatest short term volatility. This chart does not serve as a guide to expected returns, rather an indication as to how UK equities, government bonds and cash have performed over the very long term, and the level of volatility associated with these asset classes.



Source: Barclays Capital Equity Gilt Study 2014

Volatility

When considering risk the term 'volatility' is often used. Volatility is essentially fluctuations in the value of investments, leading to uncertain returns. In other words, the higher the level of volatility, the wider the range of possible returns, both on the upside and the downside.

In general terms, the more risk that is taken, the greater the potential returns and conversely, the greater the potential for loss.

Inflation

A key risk that investors seek to mitigate if they wish to maintain the real value of their capital is inflation. Inflation erodes the long term spending power of cash. For example, if UK inflation ran at the Bank of England's target rate of 2% over a 10 year period, cash placed in a non interest bearing account would lose in excess of 21% of its value.

Gilts and Bonds

Gilts and Bonds are fixed-interest securities, issued by Governments or companies, which promise to repay borrowed money at a fixed rate of interest.

Creating a portfolio – the balance of equities and bonds

History shows us what has happened in the past - it cannot predict the future. However, it can show the impact of short term fluctuations and the effect of this volatility over the longer term.

For example, investors need to consider how they would feel if their portfolio were to fall in value due to market conditions, such as those seen in 2008.

Equity weighting	Fixed Interest weighting	Historic Equity real return	Historic Bond/gilts real return	Combined real return	Combined volatility	Annual real return range – 1 Standard Deviation*		Annual real return range – 2 Standard Deviations*	
0%	100%	5.5%	2.5%	2.5%	9%	-6.6%	11.6%	-15.7%	20.7%
25%	75%	5.5%	2.5%	3.3%	8%	-4.9%	11.4%	-13.0%	19.5%
50%	50%	5.5%	2.5%	4.0%	9%	-5.5%	13.5%	-14.9%	22.9%
75%	25%	5.5%	2.5%	4.8%	12%	-7.7%	17.2%	-20.1%	29.6%
100%	0%	5.5%	2.5%	5.5%	16%	-10.6%	21.6%	-26.7%	37.7%

Data sources, definitions
This data was compiled from the Barclays Equity Gilt Study 2014. Equity and Fixed Interest (Bond) returns are real return pa over 50 years. Real returns take into account the income received on the assets held in the portfolio, as well as the capital appreciation of the assets. Volatility numbers are sourced from Coutts, and based on 30 years of annual returns. All numbers quoted are real returns, after the effects of inflation.

***Assumptions**
Standard Deviation* Range 1 is the range of one standard deviation, ie 66% of the time, returns will be in this band.
Standard Deviation* Range 2 is the range of two standard deviations, ie 95% of the time, returns will be in this band.

Equity Standard Deviation	16.1%
Fixed Interest (Bond) Standard Deviation	9.1%
Correlation	0.052

In order to explain the above table, a portfolio invested 50% in UK Equities and 50% in UK government bonds would have produced an average annual real return of 4.0% over the 50 year period to 2014.

However, due to the volatile nature of the underlying investments, history would suggest that 66% of the time (one Standard Deviation) the annual return would range between -5.5% and +13.5% on a per annum basis. Whilst this range of returns would be the most common, if we extend the range to 96% of the time (or two Standard Deviations) the range of expected returns would widen substantially to -14.9% to +22.9%.

Standard Deviation*:
Measures the dispersion of returns over a given period around the mean (average) return. A high standard deviation shows a wide dispersion of returns and is indicative of greater volatility.

Volatility:
The relative rate at which the price of an asset moves up and down. Volatility for equities for example tends to be calculated by reference to the annualised standard deviation of the daily change in price. If the price of an investment moves up and down rapidly over short periods of time, it has high volatility.

Quantifying risk within Adam Investment Portfolios

The following table illustrates how Adam Investment Portfolios quantify risk and can be used by investors to help them consider their own attitude to investment risk, or their 'risk tolerance'.

Risk category	Minimal	Low	Medium	High
Equivalent Adam Investment Portfolio	N/A	N/A	**Lower end** – Adam Investment Income & Capital Preservation. **Upper end** – Adam Investment Balanced.	Adam Investment Growth.
Overall description	The priority is for the investments to be secure and not decline in value. As a result, such investors will be invested in cash, and accept that any gains may not keep pace with inflation. Price fluctuations in such portfolios should be minimal.	Low risk investors (risk averse) can accept the risk of a relatively small capital loss in order to achieve returns that may exceed inflation. Such portfolios will be invested in fixed interest securities.	Medium risk investors (moderately risk tolerant) accept a degree of capital risk in trying to achieve returns in excess of inflation. Such investors accept the risk of capital loss and price volatility with their investments in order to generate the returns that they are seeking. Such portfolios are biased towards equity investments and as such portfolio values can fluctuate significantly as shown on pages 5 and 6.	High risk investors (very risk tolerant) are seeking to maximize the return from their investments and accept a high risk of capital loss and are willing to tolerate significant volatility in valuation in order to meet their investment requirements. Such mandates tend to be exclusively invested in equities and as such portfolio valuations can fluctuate significantly as shown on page 7.
Time horizon	This would tend to be most suited to investors with less than a 3 year investment time horizon. Investors wishing to invest with minimal risk for more than 3 years, need to be aware of the potential capital erosion to the real value of the sum invested caused by inflation.	This would tend to be most suited for investors with a minimum 3 year investment time horizon.	This would tend to be most suited for investors with a minimum 5 year investment time horizon.	This would tend to be most suited for investors with a minimum 8 year investment time horizon.
Typical asset classes	Cash deposits	A combination of Cash and Bonds (Government and Corporate) via collective funds or direct holdings.	A combination of Cash, Bonds (Government and Corporate), Equities, Property Funds. All asset classes will be accessed via a combination of direct holdings and collective investment vehicles.	A combination of Cash, Bonds (Government and Corporate), Equities, Property Funds. All asset classes will be accessed via a combination of direct holdings and collective investment vehicles.
Typical asset allocation*	100% Cash	95% Bonds, 5% Cash	Medium risk encompasses a wide range of individual expectations and as such we illustrate a top end and lower end spectrum in terms of allocation and volatility. The higher the equity content the more risk portfolios are exposed to. Lower end 40% UK Equities, 10% International Equities, 45% Bonds, 5% Cash. Upper end 60% UK Equities, 15% International Equities, 20% Bonds, 5% Cash.	75% UK Equities, 20% International Equities, 5% Cash.

*These asset allocations are illustrative and may vary depending on market conditions and valuation.

Risk category	Minimal	Low	Medium		High
			Lower end	**Upper end**	
Volatility***	As Adam Investment do not offer such portfolios, we do not have the historic data to show this information but volatility of returns is likely to be very low.	As Adam Investment do not offer such portfolios, we do not have the historic data to show this information but volatility of returns is likely to be low.	5% - 15% (most likely****)	7.5% - 15% (most likely****)	10% - 25% (most likely****)
Maximum loss over the past 5 years**	Following the introduction of the Financial Services Compensation Scheme (2010), £85,000 is currently protected. Prior to this the amount protected was £50,000.	Adam & Company do not have historic data for such portfolios as we have not managed such mandates in sufficient volume to give a meaningful sample.	-7.4%	-8.7%	-10.2%
Liquidity	Such investments are likely to be highly liquid, but investors need to be aware that some deposits require fixed term investment.	Due to the nature of the asset classes the portfolios should be realisable within 7 days. In some circumstances portfolios may hold some Funds that could take up to one month to settle (Please note in abnormal market conditions liquidity risk may be higher). Investment returns are not guaranteed and you could get back less than your original investment.	Due to the nature of the asset classes the portfolios should be realisable within 7 days. In some circumstances portfolios may hold some Funds that could take up to one month to settle. Investment returns are not guaranteed and you could get back less than your original investment.		Due to the nature of the asset classes the portfolios should be realisable within 7 days. In some circumstances portfolios' may hold some Funds that could take up to one month to settle. Investment returns are not guaranteed and you could get back less than your original investment.
Counterparty risk†	Cash deposits in UK Banks are covered by the Financial Services Compensation Scheme (FSCS) up to the value of £85,000. Investment business is covered up to a maximum of £50,000 per person.	Typically our portfolios' primary direct exposure to counterparty risk is via government bonds. There may be exposure to direct corporate bonds. Counterparty risk is generally mitigated by using collective investment vehicles for corporate bond exposure. Exposure to derivatives is typically limited to collective investment vehicles, within which the primary aim is to mitigate risk.	Typically our portfolios' primary direct exposure to counterparty risk is via government bonds. There may be exposure to direct corporate bonds. Counterparty risk is generally mitigated by using collective investment vehicles for corporate bond exposure. Exposure to derivatives is typically limited to collective investment vehicles, within which the primary aim is to mitigate risk.		Typically our portfolios' primary direct exposure to counterparty risk is via government bonds. There may be exposure to direct corporate bonds. Counterparty risk is generally mitigated by using collective investment vehicles for corporate bond exposure. Exposure to derivatives is typically limited to collective investment vehicles, within which the primary aim is to mitigate risk.

**This number is taken from our Asset Risk Consultant PCI report. It shows how much portfolios fell in the past 5 years. It represents the worst loss if a client were to sell out of the portfolio at the bottom point.

***The measure used to assess the portfolios' risk is 5-year volatility of monthly returns. This methodology is inspired from the EU Regulator's Synthetic Risk Return Indicator calculation.

****This is not guaranteed, and in extraordinary or extreme circumstances, the volatility range could exceed this.

†This is the risk to each party of a contract that the other party will not live up to its contractual obligations.

The above volatility bands are defined by back-testing and stress-testing the portfolios' benchmark asset allocation over a long period of time (in excess of 20 years). The aim is to estimate the 5-year rolling volatility of the portfolio over a range of market conditions and with varying asset allocation positions. The 'most likely' band covers at least two-thirds of the potential risk outcomes.

Shaded areas represent portfolios that Adam Investment does not offer as standard. Clients interested in this type of portfolio can speak to an Adam Financial Planner for advice.

How have Adam Investment portfolios performed over time?

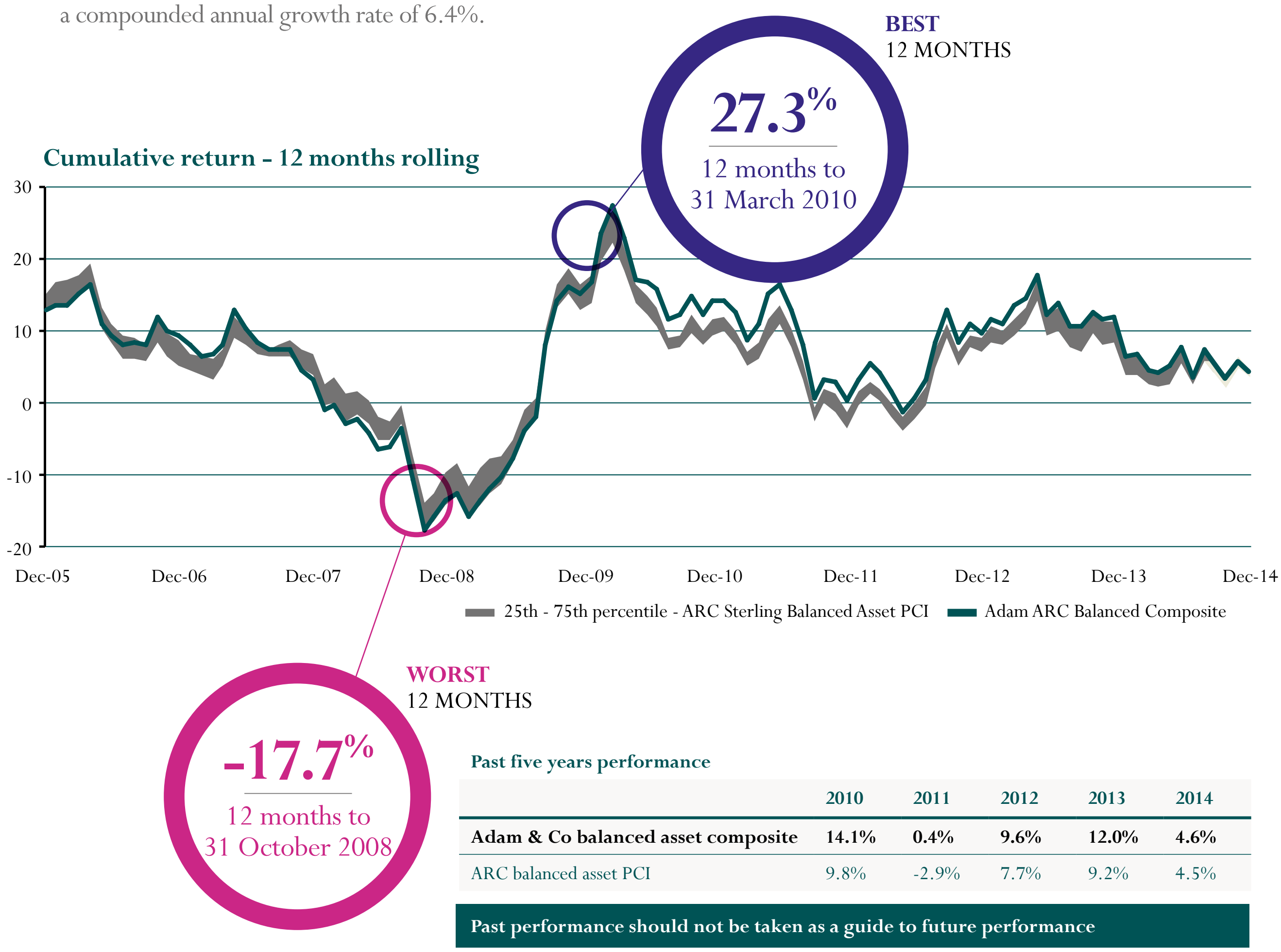
To demonstrate the returns that actual Adam portfolios have experienced over the past 10 years, the charts below illustrate the cumulative 12 month returns of our average client portfolios (over £250,0000 in size). The following data is supplied by Asset Risk Consultants (ARC), who take our portfolio and performance data and compare it to our peer group on a risk adjusted basis. The following pages show the ARC data for 'Balanced', 'Steady Growth' and 'Equity Risk' ARC composites, which broadly correspond to the Adam Investment 'Income and Capital Preservation', 'Balanced' and 'Growth' benchmarks respectively.

Performance

We regularly update our performance information to reflect the most up to date data. This information is available on request. ***Please note: Investment returns are not guaranteed. The value of investments can go down as well as up and you may not get back your original investment.***

1. Adam Investment 'ARC Balanced Composite' Medium Risk Investors – Lower end of medium spectrum

This chart shows the rolling 12 month return that clients invested at the lower end of the medium risk profile experienced. At the worst point in the cycle, the 12 month return was -17.7%, whilst at the best point in the cycle that return was 27.3%. The cumulative returns for such portfolios for the past 10 years (up until end of December 2014) were 86.8%, or a compounded annual growth rate of 6.4%.



Past five years performance

	2010	2011	2012	2013	2014
Adam & Co balanced asset composite	**14.1%**	**0.4%**	**9.6%**	**12.0%**	**4.6%**
ARC balanced asset PCI	9.8%	-2.9%	7.7%	9.2%	4.5%

Past performance should not be taken as a guide to future performance

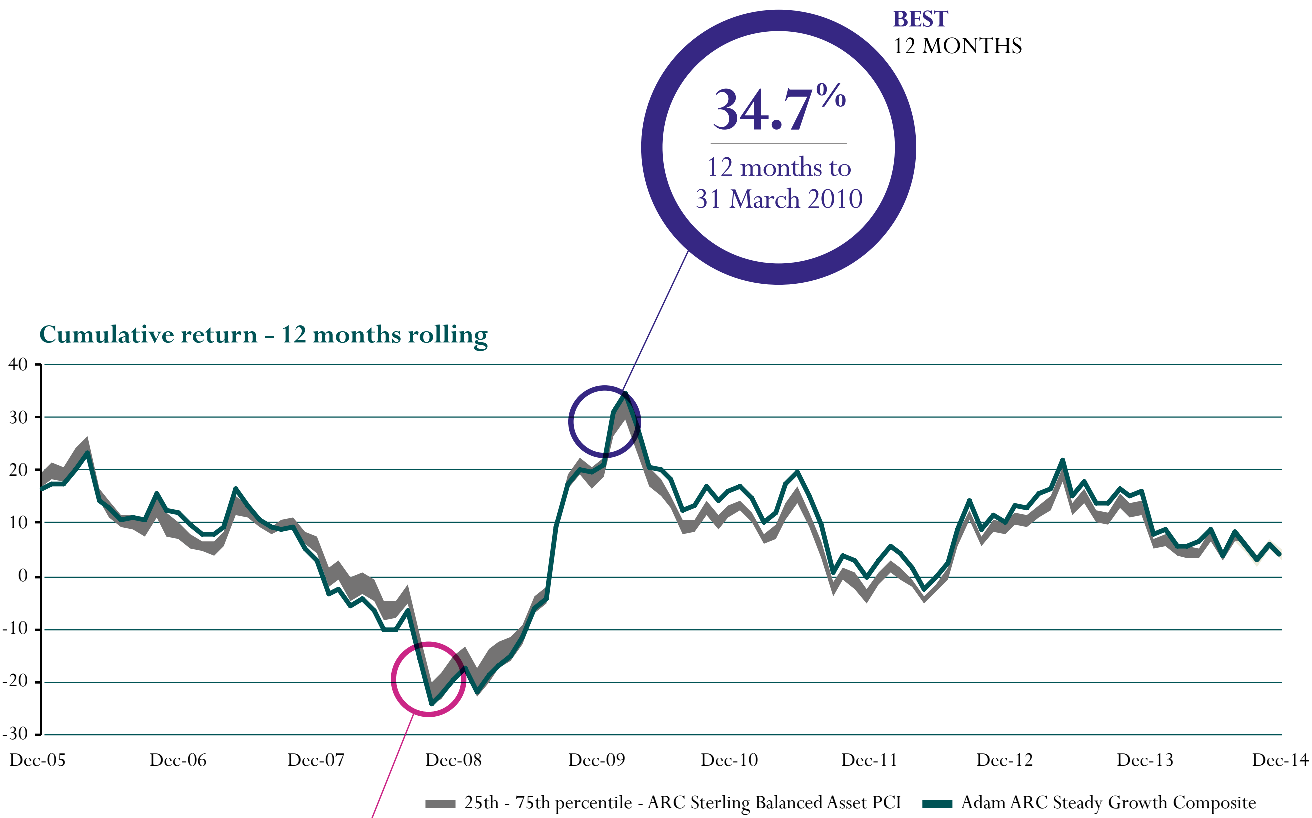
Source: Adam/ARC Sterling PCI.

The 25th-75th percentile relates to a comparison of around 50 discretionary private client managers contributing real performance data. For more information on ARC PCI please visit www.assetrisk.com.

Performance figures are shown on a total return basis net of all fees.

2. Adam Investment ‘ARC Steady Growth Composite’ Medium Risk Investors – Upper end of medium spectrum

This chart shows the rolling 12 month return that clients invested at the upper end of the medium risk profile experienced. At the worst point in the cycle, the 12 month return was -24.3%, whilst at the best point in the cycle that return was 34.7%. The cumulative return for such portfolios for the past 10 years (up until end of December 2014) was 99.9%, or a compounded annual growth rate of 7.2%.



Past five years performance

	2010	2011	2012	2013	2014
Adam & Co steady growth composite	**16.0%**	**-0.4%**	**10.3%**	**16.0%**	**4.4%**
ARC steady growth PCI	11.9%	-4.2%	8.9%	12.5%	4.7%

Past performance should not be taken as a guide to future performance

Source: Adam/ARC Sterling PCI.

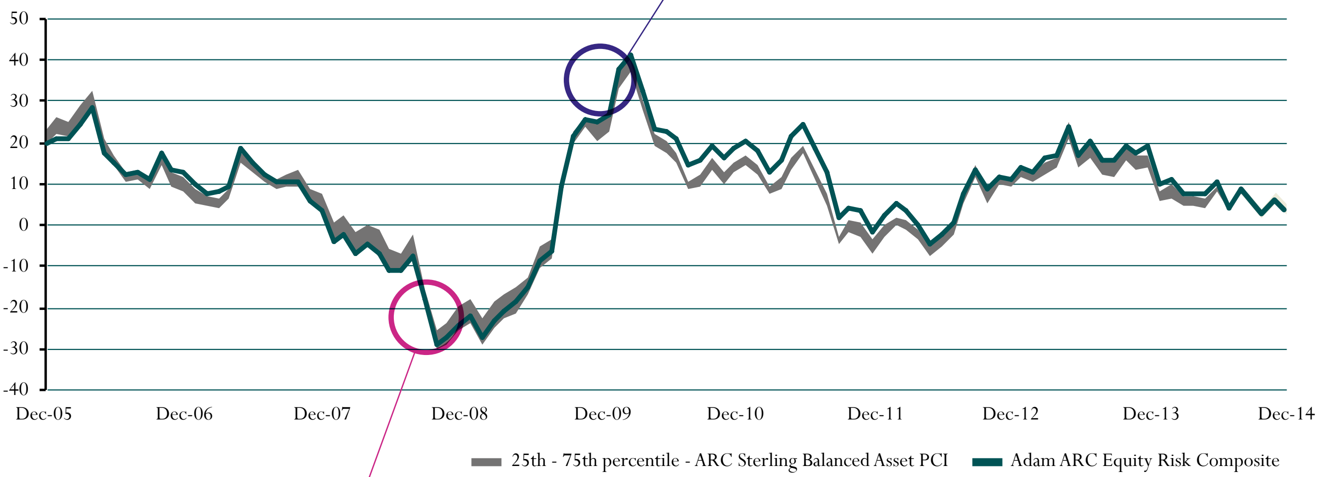
The 25th-75th percentile relates to a comparison of around 50 discretionary private client managers contributing real performance data. For more information on ARC PCI please visit www.assetrisk.com.

Performance figures are shown on a total return basis net of all fees.

3. Adam Investment 'ARC Equity Risk Composite' High Risk Investors

This chart shows the rolling 12 month return that clients invested in a high risk profile experienced. At the worst point in the cycle, the 12 month return was -29.1%, whilst at the best point in the cycle that return was 41.6%. The cumulative return for such portfolios for the past 10 years (up until end of December 2014) was 111.3%, or a compounded annual growth rate of 7.8%.

Cumulative return – 12 months rolling



Past five years performance

	2010	2011	2012	2013	2014
Adam & Co equity risk composite	**18.5%**	**-1.6%**	**11.1%**	**19.0%**	**3.7%**
ARC equity risk PCI	14.0%	-5.9%	10.1%	16.1%	4.1%

Past performance should not be taken as a guide to future performance

Source: Adam/ARC Sterling PCI.

The 25th-75th percentile relates to a comparison of around 50 discretionary private client managers contributing real performance data. For more information on ARC PCI please visit www.assetrisk.com.

Performance figures are shown on a total return basis net of all fees.

Important Information

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