REPORT TO:	**FINANCE AND MANAGEMENT COMMITTEE**	**AGENDA ITEM: 11**
DATE OF MEETING:	**31st AUGUST 2017**	**CATEGORY: RECOMMENDED**
REPORT FROM:	**DIRECTOR OF FINANCE and CORPORATE SERVICES**	**OPEN**
MEMBERS' CONTACT POINT:	**KEVIN STACKHOUSE (01283 595811)** Kevin.stackhouse@south-derbys.gov.uk	**DOC:** u/ks/treasury management/lending policy/Lamit Property Fund/Land Property Fund Proposal
SUBJECT:	**THE LOCAL AUTHORITIES' PROPERTY FUND**	**REF:**
WARD(S) AFFECTED:	**ALL**	**TERMS OF REFERENCE: FM 08**

1.0 Recommendations

1.1 That the policy test for long-term investments as detailed in the report is approved and the Council's Investment Strategy is updated accordingly.

1.2 That the CCLA Lamit Property Fund is added to the Council's approved Counterparty List and the Investment Policy and Treasury Management Strategy are updated accordingly.

1.3 That the Council invests £1m into the CCLA Lamit Property Fund for an indefinite period, subject to quarterly review.

1.4 That progress on the value of the cash deposit together with dividend returns is reported to the Committee on a quarterly basis.

2.0 Purpose of the Report

2.1 To consider a proposal to invest a proportion of the Council's cash deposits into a local authority property fund.

3.0 Detail

3.1 Recent financial and treasury management reports to the Committee have highlighted the increasing level of cash and reserves available for deposit.

3.2 All current deposits are short-term (less than 364 days) and tend to be held in instant access accounts, although longer fixed-term arrangements exist with other local authorities. The Council's Lending Policy is to ensure that security and liquidity are paramount in all investment decisions.

3.3 In recent years, the number of named investors on the approved Counterparty List has diminished due to stricter lending criteria and the reduction in credit ratings of several financial institutions.

3.4 In addition, spreading the Council's deposits is proving more difficult within the credit limits set for each type of investment. Typically, the Council has between £10m to £20m on deposit during the year.

3.5 Given this level of cash and reserves, some research has been undertaken to determine whether there are options to invest longer-term and to generate a greater return on the cash deposited.

3.6 There are several options available, many of which would involve the use of financial instruments such as Bonds and Treasury Bills. These instruments are regulated and tend to generate greater returns.

3.7 However, they are more risky, can involve intermediaries and carry a cost. In addition, they can create complications on how they are accounted for and shown on the Council's Balance Sheet. The Council could also directly buy property or invest in the property market.

3.8 The potential risks involved with all of these options, would probably fall outside the current risk appetite in the Council's Lending Policy which is designed to minimise risk. However, it is considered that the main drawback of the Council's current Policy is that it is not adequately diversified given the current and forecasted level of cash reserves.

Longer-term Investments

3.9 Longer-term deposits (greater than 1-year) can be more risky in that capital is tied up and the value of that capital can reduce, or even disappear altogether. This has been the case in the recent past where some local authorities have incurred some substantial losses in their longer-term investment portfolio.

3.10 There are many authorities in the Council's situation in that tightening of investment criteria, coupled with cash reserves, has increased demand for diversification and to look beyond traditional cash deposits. In addition, some authorities are looking for a greater return given the current level of low interest rates.

3.11 Longer-term investments are just that – the investment needs to be made into the longer-term so that any downturn in capital valuation or yields is evened out over a period of years.

Policy Test (Risk Appetite)

3.12 In considering diversification and in making a decision to enter into a longer-term investment, it is recommended that the following criteria are met:

- The Council can afford to make a longer-term investment of up to 5-years and beyond, i.e. a proportion of cash reserves will never be required immediately.

- The investment model or tool is well-established, regulated and ideally used by other local authorities.

- Past and current performance is strong and has recovered following downturns in the economic cycle, i.e. its prospects for sustainability are good.

- The risk of capital loss is minimal.

- There is flexibility to withdraw Capital.

- The yield is greater than short-term interest rates.

- There are no complicated administrative or technical arrangements and costs associated with investment are minimal.

- The accounting arrangements meet the Local Government Code of Practice.

3.13 Following discussions with the Council's Treasury Advisors, the Council's options are limited when compared to the above policy test.

3.14 However, there is one option available which has been considered in some detail. This investment model effectively entails buying into a local authority property fund.

CCLA LAMIT Property Fund

3.15 This Fund exists solely for local authorities, including town and parish councils. Although the Fund has been in existence since 1972, it is only in recent years that it has been used and grown significantly.

3.16 Currently, there are 186 local authority members and the Fund had a total capital value of approximately £765m as at 30th June 2017. Individual investments range from £25,000 (minimum) to £50m (maximum).

Governance

3.17 The Fund is managed by the CCLA (Churches, Charities and Local Authorities) which is an organisation set up over 50 years ago to manage investments on behalf of charities, religious organisations and the public sector.

3.18 CCLA are a limited company and act as Fund Managers. They manage properties and provide the administration for the operation of the Fund. CCLA manage several funds and they are authorised and regulated by the Financial Conduct Authority.

3.19 The Fund itself is governed by a separate organisation – the Local Authorities' Mutual Investment Trust (LAMIT). LAMIT acts as the trustee of the Fund. This body is controlled by appointees of the Local Government Association, the Convention of Scottish Local Authorities, the Northern Ireland Local Government Committee, together with investors in the Fund.

3.20 LAMIT are independent and set the investment strategy, risk profile and review performance.

Accounting Matters

3.21 Investment in property funds normally counts as capital expenditure under local authority accounting regulations.

3.22 However, the Fund is approved by HM Treasury under the 1961 Trustee Investments Act and this gives the Fund a unique accounting basis for local authorities. The capital investment is recorded as a long-term cash investment on the Balance Sheet at the initial amount (value) invested, whether the cash amount appreciates or depreciates from year-to-year.

3.23 Therefore, the General Fund is protected from fluctuations in the capital value of unit prices and dividends are treated as revenue income. Dividends are not subject to tax.

3.24 When the cash is withdrawn, any appreciation counts as a capital receipt. Any depreciation upon withdrawal compared to the original cash investment, would need to be made good from other resources.

Impairment

3.25 An investment in the Fund would only be considered impaired if there was a significant or prolonged decline in the unit price below the level at which the units were bought. In that case, the loss at that time would be accounted for in the General Fund.

Operation of the Fund

3.26 When an authority invests in the Fund, it buys "units". As an authority enters the Fund, the cash injection is used to purchase properties and increase the overall property portfolio.

3.27 The property managers (employed by CCLA) manage properties, sell and buy new properties, etc. Some cash reserves are kept in the Fund for liquidity and as a contingency.

3.28 Payments in and out of the Fund are strictly regulated and trading days, when cash transactions take place, occur on only one day per month. Notice is required and this allows CCLA to manage cash flow accordingly.

Objectives of the Fund

3.29 The objectives are fairly simple in that the Fund is designed to generate a high level revenue return based on the initial cash investment and to provide capital appreciation over a longer-term.

The Current Property Portfolio

3.30 The Fund is used solely to invest in UK based commercial, industrial and retail property. Property is currently owned all over the UK and includes shops, shopping centres, warehousing, conference centres and offices.

3.31 Property is rented and leased out to tenants in order to generate a yield based on the value of each asset. Property subsequent sold at a profit as part of portfolio management, is returned to the Fund.

3.32 Property is managed by CCLA property managers and this includes marketing, void management and lease arrangements, etc.

3.33 The current portfolio includes 57 individual holdings with the principal holdings being in offices and retail parks in London, the Bracknell Arena, Bristol Retail Park, the Peugeot facility in Coventry, Cambridge Science Park, together with property in Leeds and Edinburgh.

3.34 Tenants include multi-national companies, major retail outlets and more medium-sized, local businesses. The latest published vacancy rate was 6.4% with unexpired leases averaging 5.2 years.

3.35 A full list of the portfolio is included in the links to the background papers in **Section 7**.

Investing

3.36 There are no direct entry or exit fees and payments in and out of the Fund can be made at any time subject to the restricted trading days as detailed earlier in the report. Therefore, there is no fixed term maturity arrangement and withdrawals can be made at any time.

3.37 However, it should be noted that if cash is not invested over a longer-term, the capital value of the investment will likely depreciate.

3.38 CCLA charge an annual management fee of 0.65% to cover costs, but this is deducted and included in the net dividend paid. Dividends are paid quarterly.

3.39 The Fund is effectively a unit trust fund. When an investment is made into the Fund, the cash deposit buys units. As at June 2017, a unit was valued (**offer price**) at £3.10p. So, for example, if £1m was invested, this would buy 322,581 units *(£1m / 3.10p*).

3.40 As at June 2017, the **bid price** of a unit was £2.86p each. This is the price which determines the capital amount repaid on exiting the Fund. Therefore, effectively the cash deposit of £1m is immediately reduced to £923,354 (*322,581 * £2.86*).

3.41 The difference between the offer and the bid prices is maintained at around 7.75% and this reflects the cost of entry. This covers the cost of stamp duty of buying new property (5%) together with 2.75% to cover professional fees and other costs. Except for the on-going management cost deducted from dividends, no other costs are then payable.

3.42 Over a period of time, the offer and bid prices generally rise but the differential between the two prices of 7% to 8% remains the same.

3.43 The principle of the Fund is that over time, the bid price of a unit, in this example, of £2.86p will rise above the offer price paid of £3.10p. For example, say in 5 years, if the bid price has risen to £3.40p, the £1m would be worth just under £1.1m (*322,581 * £3.40p*).

3.44 In the meantime, dividends are paid on the initial cash deposit, disregarding any fluctuations in the value of the capital investment. So, in the above example, the quarterly dividend would be paid on the £1m – the 322,581 units held for as long as the cash deposit remained in the Fund.

3.45 In this example, if a dividend of 13p per unit was declared, this would equate to £41,936 (*322,581* * 13p) – a return of 4.2% on the £1m invested.

Past Performance of the Fund

3.46 <u>It should be noted that past performance of the Fund is no guarantee of future performance</u>.

3.47 Property valuations and prices can vary and are subject to the economic cycle.

3.48 Yearly dividends (*net of the management fee*) over the last 10 financial years are shown in the following table.

Financial Year	Dividend per Unit (in pence)	%'age return
2007/08	0.1264	4.09%
2008/09	0.1606	5.20%
2009/10	0.1273	4.12%
2010/11	0.1433	4.64%
2011/12	0.1340	4.34%
2012/13	0.1284	4.16%
2013/14	0.1148	3.72%
2014/15	0.1342	4.34%
2015/16	0.1396	4.52%
2016/17	0.1319	4.27%

3.49 These returns can be compared with the average 7-day market rate upon which the Council has been paid interest on its short-term cash deposits.

3.50 Besides 2007/08, the returns in the above table have been well above the average market rate and this rate has been no higher than 0.6% since 2009/2010 when the Bank Base Rate was reduced from 1% to 0.5%. The equivalent rate was only 0.36% in 2016/17 following the reduction in the Bank Base Rate to 0.25% in August 2016.

Capital Growth

3.51 The capital value of the Fund is based on the net asset value per Unit. This unit value lies between the offer and bid prices.

3.52 The average net asset value of a unit has increased from £2.27p in 2013 to £2.87p per unit as shown in the following table.

	31/3/13	31/3/14	31/3/15	31/3/16	31/3/17
Offer (pence)	2.41	2.61	2.92	3.13	3.15
Bid (pence)	2.23	2.23	2.43	2.75	2.78
Net Value (pence)	**2.27**	**2.44**	**2.74**	**2.92**	**2.87**

3.53 The table shows how the net value price can fluctuate, although the direction of travel has been upwards in this period. There was a reduction between the 2016 and 2017 financial years.

3.54 However, the bid price still rose marginally. If an investment had been made in March 2013 at an offer price of £2.41p per unit, those units would have been worth £2.78p by March 2017.

3.55 Capital growth over a much longer-term is shown in the following table.

CAPITAL GROWTH		Per Year	Cumulative	Inflation
1	2004	22%		3.00%
2	2005	17%	39%	2.80%
3	2006	20%	59%	3.20%
4	2007	-2%	57%	4.30%
5	2008	-30%	27%	4.00%
6	2009	-1%	26%	-0.50%
7	2010	17%	43%	4.60%
8	2011	6%	49%	5.20%
9	2012	4%	53%	3.20%
10	2013	9%	62%	3.00%
11	2014	14%	76%	2.40%
12	2015	9%	85%	1.00%
13	2016	-2%	83%	1.80%

3.56 The table shows that the capital value of the Fund has grown by 83% cumulatively since 2004. Clearly, over a longer period, the timing of entry into and exit from the Fund, will determine the capital appreciation over this time.

3.57 The large reduction in 2008 was due to the “credit crunch”. The smaller reduction more recently in 2016 was put down to the uncertainties relating to the EU referendum and the outcome of Brexit.

3.58 If an investment had been made in the Fund in 2008 at the time of a significant reduction in the capital value, this reduction would have been offset by 2013 from subsequent increases.

3.59 These statistics perhaps demonstrate that any investment in property needs to be made for the longer-term. Looking at the general value of property more historically, overall values have consistently increased since 1970.

3.60 The exceptions were in 1974, where the value of property fell at a rate similar to that evidenced in 2008; this was put down to the UK economic recession at that time. There were smaller decreases in 1990, 1991 and 1992 due a downturn in the UK economy and global financial markets.

How much could the Council Afford to Invest

3.61 The value of the Council’s reserves totalled approximately £26.1m as at 31st March 2017 as shown in the following table.

General Fund	£8.4m
Earmarked Reserves (incl Section 106)	£8.5m
Housing Revenue Account	£3.7m
Capital Receipts	£4.3m
Major Repairs / Debt Repayment (HRA)	£1.2m

3.62 The Council typically has anywhere between £10m and £20m invested on a daily basis. In addition, the Council is required to maintain a minimum balance of at least £2m - £1m each for the General Fund and HRA. Based on the current MTFP and HRA Financial Projection, it is considered very unlikely that the Council’s overall reserves will fall to anywhere near this level over the next 5-years.

3.63 Therefore, it is considered that the Council could afford an initial investment of £1m. This would allow a contingency position regarding the minimum balance requirements.

Joining the Fund

3.64 Authorities have to formally apply to join the Fund having sought their own internal approvals and are subject to a “credit check” although this is a fairly straightforward process. The CCLA reserve the right to refuse an application but this would not be anticipated.

3.65 Authorities have the flexibility to make partial withdrawals of capital subject to notice and the allocated trading day and also the option of buying more units and adding to the original investment.

The Risks and Benefits

3.66 The main risk has already been highlighted in that property valuations and prices can vary and indeed reduce. This is dependent on prevailing economic conditions.

3.67 In addition, dividend yields can vary and are not guaranteed unlike fixed bank deposits. Yields from the Fund have consistently been well above short-term interest rates in recent years.

3.68 The latest forecast (June 2017) for short-term interest provided by the Council's Treasury Advisors, shows the current Bank Base rate remaining unchanged at 0.25% until well into 2020. Their risk analysis shows forecasts at no more than a 0.25% variation either side in the interim.

3.69 The data detailed earlier does however highlight, that property values usually appreciate over time, well in excess of inflation and recover from major downturns. Clearly though, this cannot be guaranteed.

3.70 Following the initial uncertainty immediately following the UK's decision to leave the EU in 2016, property values did reduce. However, they have since recovered and have recently started to rise over the previous 9 months. Discussions with both the CCLA and the Council's Treasury Advisors confirm that uncertainty will probably exist in the economy until the outcome of Brexit is agreed.

3.71 The LAMIT Fund is a simple and efficient route to invest in property. Whereas a directly held property portfolio requires a substantial scale to achieve an appropriate spread of investments, a unitised approach can work regardless of the scale of the investor.

3.72 The pooled Fund allows the efficient management and maintenance of the underlying property and offers a geographical and diverse spread. Furthermore, this Fund offers unique accounting benefits for local authorities.

3.73 Although units can be cashed at any time, it is not a liquid asset given the limited trading days and notice required to withdraw cash. Even the literature produced by the Fund Managers, stresses "*that the investment horizon for investors in the Fund should be measured in years*".

Comparison to the Policy Test

3.74 The Fund has been assessed against the 8 points recommended earlier in the report.

Policy Test	**Comments**
The Council can afford to make a longer-term investment of up to 5-years and beyond, i.e. a proportion of cash reserves will never be required immediately.	The proposal includes an investment of £1m as detailed earlier in the report.
The investment model or tool is well-established, regulated and ideally used by other local authorities.	The LAMIT Property Fund has existed since 1972 and currently has 186 local authority unit holders. The CCLA, as property managers, are regulated by the Financial Conduct Authority.
Past and current performance is strong and has recovered from downturns in the economic cycle, i.e. its prospects for sustainability are good.	As detailed in the report. Good capital growth over the medium to longer-term and annual dividends paid. The Fund recovered from the Credit Crunch in 2008/09 and has since grown in value and in the number of unit holders.
The risk of capital loss is minimal.	The capital value could depreciate but whilst property is held, the units will always be of some value. Unless the Fund is liquidated, the capital is unlikely to be lost in its entirety.
The yield is greater than short-term interest rates.	The report highlights that annual returns have been well above short-term interest rates over recent years. The general forecast for short-term interest rates is that they will remain at or around current levels until 2020.
There is flexibility to withdraw Capital.	The investment, in the form of Units, can be withdrawn at any time subject to specified trading days and a notice period. The investment is not subject to a specified maturity period.
There are no complicated administrative or technical arrangements and costs associated with investment are minimal.	This is all undertaken by the Fund Managers for a fixed fee which is deducted before the dividend is declared and paid.
The accounting arrangements meet the Local Government Code of Practice.	The Fund is compliant and provisions exist in the Local Authority Accounting Code of Practice under International Accounting Standard 39. The unique status of the Fund from an accounting perspective is detailed in the report.

Conclusion

3.75 As far as it can be ascertained, the Council has never invested its cash reserves on a long-term basis. In addition, the Council has never suffered any loss of capital that it has deposited.

3.76 There is perhaps always a risk with any type of investment. The current "bail-in" regulations should a large bank or financial institution face financial difficulties, potentially mean that short-term investments could be lost with a traditional UK based bank for example, as the Government can longer intervene and bail out any of the so-called "big banks".

3.77 The Council's current Lending Policy and Counterparty List is very risk averse, but it generally accords with Government guidelines, i.e. security and liquidity takes precedence over yield.

3.78 Funds are deposited in instant access accounts, the Bank of England and other local authorities. The risk of losing capital is negligible.

3.79 The Counterparty List is however not diverse enough to deal with the amount of cash and reserves held by the Council. In addition, with the current level of historically low interest rates, the Council is generating a very low rate of return.

3.80 Consideration should be given as to whether a proportion of the Council's cash and reserves should be utilised and invested longer-term, to generate additional income for the Council and to eventually generate a capital receipt. Clearly, the risk will increase and there is perhaps a balance to be struck.

3.81 The LAMIT Fund clearly has a track record of producing a constant yield and an increase in capital value. It is a large local authority fund and this does reduce the risk and overall, it is considered that it meets the 8-point policy test as detailed earlier in the report.

3.82 It is recommended that entry into the Fund should be sooner rather than later as property values and the offer price are increasing. At some point, history shows that there is likely to be a dip in property values and this would need to be cushioned from long-term investment, although the exit from the Fund may precede this.

4.0 Financial Implications

4.1 As detailed in the report

5.0 Corporate Implications

5.1. None directly

6.0 Community Implications

6.1 None directly

7.0 Background Papers

7.1 Further details of the Fund, including analysis of performance and accounts, etc. are available at:

https://www.ccla.co.uk/investment-solutions/fund/the-local-authorities-property-fund