

HAMPSHIRE COUNTY COUNCIL

Decision Report

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Contact name: Harvey Cole

Tel: 01962 865930

1. Summary

- 1.1. This report was circulated to Panel members at the time of the last meeting on 28 May 2010. It is included on the Agenda for this meeting to allow a discussion if necessary.
- 1.2. **I have added a footnote in section 7 to the discussion of the globalisation of the UK equity market.**
- 1.3. **I have also added some comments on tobacco shares, in section 8, following the discussion at the Panel meeting on 28 May 2010.**
- 1.4. The report sets out my views of the economic and financial situation as of 20 May 2010. Given the magnitude of recent developments, both global and national, and the volatility of the political scene, I concentrate on the broader issues in an attempt not to be too confused by the rapidly shifting pattern of detail. With luck clarity will gradually emerge from the few points in the landscape that appear to be relatively fixed.
- 1.5. I therefore start with a consideration of the global economy, and then turn to the situation in the UK before looking a little more closely at the investment context and matters directly affecting the implications for the pension fund.

2. The global economy

- 2.1. Just when you might have thought it was safe to put your head above the parapet again and look forward to a gradual but continuous recovery from the financial smash of 2008, a new bout of currency risk and contagion has erupted. Promising signs of steady economic growth are being overlaid with erratic layers of ash from the very small volcano known as Greece.
- 2.2. This is a sobering reminder of how closely interlinked the international financial system has become. While less than 3 per cent of the GDP of the

Eurozone is accounted for by Greece, that country defaulting on its international debt, or actually leaving (or being ejected) from the Eurozone itself, would have enormous repercussions and knock-on effects. This is because of the consequent collapse in the value of Greek government bonds, of which some \$300 billion (at face value) are held by other countries – with the largest share being German-owned (with France not far behind). Not merely does this threaten the creditor nations with having to raise large sums to plug the resulting gap in their own balance sheets as they write off their Greek assets, but it also encourages speculators to start hounding the next potential victim who is suspected of having a vulnerable currency – which is all too likely to prove a self-fulfilling prophecy.

- 2.3. The most dispiriting thing about the whole prolonged episode has been the failure of the leading nations to appreciate the scale of the problem and to get to grips with it promptly, when the scale of the damage and the consequent collateral casualties would have been much reduced. Much vaunted international solidarity in the face of crisis proved no more than an illusion, with France and Germany more concerned to disclaim any responsibility for events, while also claiming victories over each other as successive half-solutions were wheeled out.
- 2.4. Eventually reality began to break through, and it was seen that any solution confined to ‘punishing’ Greece for the crimes and misdemeanours of its previous government would be less than useless. While the answer was therefore not to make a drachma out of the drama, the dithering and delay that finally led to the massive mobilisation of \$750 billion from Europe (including non-Eurozone countries), the US and the European Bank may turn out to be no more than an enormous sticking plaster.
- 2.5. This money does little or nothing to resolve the indebtedness problem – either of Greece itself or of other suspectedly vulnerable countries. The US Federal Reserve is prepared to provide support to other countries which may come under speculative attack, and the European Bank has promised to make loans against state bonds at above their current market value. The result is perhaps the largest one-way option ever known to undertaking unwise investment. Speculators can now again be highly profligate in pressing high-interest loans on cash-strapped countries in the virtually certain knowledge that when (rather than if) default occurs, they will be bailed out.
- 2.6. While the immediate flow of blood may have been staunched, little or nothing has been done to repair the underlying damage. Indeed, while the new liquidity will sustain activity for perhaps two or three years, some very large pigeons indeed are beginning to look for a home to roost in.
- 2.7. Critically, the US is taking a large gamble by making swap arrangements with foreign banks to provide them with dollars. This does help them buy time, but it is far from clear that that purchase will effectively lead to success in eliminating the indebtedness fast enough to restore adequate equilibrium. And, while the stronger European economies could help the weaker ones meet their obligations, it would be a bold observer of the political scene who would place much money on Europe finally acting in its

common interest next time the underlying crisis goes from grumbling to eruption again.

- 2.8. For this to change, recognition is needed that the traditional burden of adjustment of international imbalances must cease to be placed exclusively on countries that have a trading deficit. Germany appears even more intransigent than China in insisting that it should not be asked to consume more of its output domestically and that it is verging on the immoral to expect it to run down its export surplus. It seems as if it may still take a long time before the realisation sinks in that, if you insist on selling more than you buy, your customers will eventually run out of the money with which to purchase your goods.
- 2.9. To return to Greece. The most serious fact that is beginning to emerge from the fog of confusion is the virtual impossibility of the country fighting its way out of its present plight. This year it is (perhaps optimistically) planning to reduce its budget deficit from over 11 per cent of GDP to 8. Its public debt now stands at over 133 per cent of GDP. If all goes according to current plans the deficit will be heroically cut to just over 2 per cent of GDP by 2014. At the same time a decline in GDP of 4 per cent this year is expected to turn into a small growth of 1 per cent in 2012 and rise further to 2 per cent in both 2013 and 2014. Even if this is achieved, GDP will still be 4 per cent below today's level – and public debt will be 11 percentage points higher in relation to GDP than it is now.
- 2.10. The arithmetic of that is that even subsequent growth at 4 per cent a year will not provide enough to service interest on the debt, so that national income after interest has been paid will actually shrink – and that is also without making any capital repayments. Neither the Greeks themselves nor their creditors are likely to find this remotely acceptable.
- 2.11. To conclude this gloomy prognostication, similar trends, even if on a lesser scale, are emerging elsewhere. The national, or so-called sovereign, debt of the developed countries has shot up from an average of 44 per cent in 2006 to over 70 per cent today – and appears to be heading even higher. Their budget deficits are absorbing half of all saving being made in OECD countries, and the inevitable result will be to put a brake on economic growth. But the process of monetising government debt through the state purchasing its own bonds will continue in a mad rush to run fast enough to keep up with themselves.
- 2.12. This is the final working out of the credit crash of 2008 which effectively destroyed enormous amounts of real wealth based on borrowing that proved unrepayable. This 'money' still preserves a ghostly existence, but much more of it is now allocated to providing capital to support bloated bank balance sheets – which explains why banks appear stuffed with cash but are reluctant to make loans.

China

- 2.13. One of the fortunate events that has occurred in recent years is the failure of globalisation to embrace the entire world economy. Were it not for the success of the large emerging nations, together with several others in Asia and South America, in decoupling themselves from the developed world, the current crisis would have been considerably more severe.
- 2.14. Indeed, doubts over the reliance of the global economy now centre on whether or not China will be able to avoid serious overheating of its still rapidly expanding economy and thus putting a brake on the wider recovery.
- 2.15. Western observers have seized on the frantic pace of property development as a sign of impending problems. The government is attempting to restrain the continuing flood of money into new developments amid fears that the bubble may be about to burst (many newly built developments are standing empty) – and thousands of highly geared loans seem about to be written off.
- 2.16. Commentators closer to the scene take a different view. They point out that while there is indeed massive development in the cities, there is much more than property to the Chinese economy. The expansion of the infrastructure is even more important, and while, for example, the Chinese are notoriously building a new electricity plant every few days, it is not widely recognised that they are using most of these to replace inefficient and highly polluting capacity with cleaner and more energy efficient power stations.
- 2.17. Similarly, Chinese industry is swiftly building up a dominant presence in the development of energy saving machinery and equipment and is expected to account for well over half of world output of such items within the next five or six years.
- 2.18. While the gyrations of the Shanghai stock exchange attract fascinated attention, repercussions from its ups and downs do not yet exercise a significant impact on the wider economy.
- 2.19. The other key issue is of course Chinese policy on its foreign exchange rate. Americans insist that keeping the renminbi artificially low is distorting the whole pattern of international trade, and have been beginning to threaten protective measures against Chinese imports.
- 2.20. But the US has trading deficits with 90 different countries, and the gap with China accounts for less than 40% of the total. Indeed, the two-way trade between the two countries accounts for only 12 per cent of China's total foreign trade.
- 2.21. It is also significant that between 2005 and 2008, when China allowed a controlled appreciation of 20% in the renminbi, the Chinese surplus with the US actually increased by over \$100 billion, or over 60%.
- 2.22. It has also been pointed out that one inevitable consequence of a rise in the renminbi would simply be to transfer some US purchases from China to other low cost Asian countries, leaving the overall deficit little affected – but very probably damaging the profits of US subsidiaries operating in China or buying parts for assembly of manufactured goods elsewhere.

- 2.23. China and the US are also locked together by the vast Chinese holdings of US Treasury bonds and other investments. Liquidation of these would be more damaging than the continuing effects of the trade deficit. This seems to be a case when it is wise to remember the saying: 'be careful what you wish for'.

3. The UK Economy

The Task

- 3.1. What the UK has to achieve in the coming years is clear. A deficit of over 11 per cent in the national budget has to be reduced to around 3 per cent by 2015 or 2016. While the recent election led to small variations in the approach to this objective being proposed by the political parties, there was little effective difference.
- 3.2. The balance between raising taxes and cutting public expenditure is open to some, but not very much, flexibility; the phasing in of the retrenchment led to some difference of opinion; and there was dispute over the impact of alternative measures on the level of employment.
- 3.3. But the highlighted argument over whether to include an increase of £6 billion in national insurance or to find the same amount by starting sooner to cut back public spending was a red herring: eliminating 'waste' would in practice threaten more jobs than the proposed increase in NI contributions.
- 3.4. The essential part of the chosen prescription is to ensure that, throughout the period of adjustment, there is sufficient growth to enable the burden of debt to be gradually discharged without shrinking the rest of the economy.
- 3.5. The arithmetic is simple. Between this year and 2014-5 the Government will need to borrow a total of an extra £580 billion. By 2015, at an interest rate of 4 per cent, this will be costing £23 billion a year (rising from £6.7 billion this year).
- 3.6. An increase in real GDP of around 1.5 per cent a year would allow the economy to grow fast enough to keep income per head stable (after allowing for continuing population increase) and paying the interest bill. That does not seem too daunting, but it leaves little leeway for falling short.
- 3.7. The danger of a runaway deflation as interest payments eat into the national economy is therefore minimal. As far as inflation is concerned, the downward pressure on pay increases in both the private and public sectors will prove so great that incomes are likely to be almost static for the next three or four years. Hence, any increases in prices will tend to prove themselves deflationary rather than inflationary in practice.

The Rating Agencies Berated

- 3.8. The main external threat comes from the danger of sterling losing its AAA credit rating, which would mean that interest rates on further borrowing would increase and the pound would also fall on the internal exchanges.
- 3.9. At present the fate of sterling is in the hands of three so called rating agencies based in the US. They were originally established with a mandate

from the American government to vet the bonds being issued by American municipalities and to certify their level of risk of default. This determined the interest rate that investors would look for.

- 3.10. Their business gradually extended into also rating bonds issued by most governments and corporate bonds (but not shares) issued by the larger industrial and commercial companies traded on international exchanges.
- 3.11. A sea-change occurred when the spate of new-fangled financial instruments began emerging from the alphabetical jungle. The rating agencies piled in, and the scale is shown by the fact that one of them, Moody's, increased its profits from \$800 million in 2001 to over \$2 billion in 2006, with well over half of the extra coming from vetting bundles of sub-prime mortgages put together by the investment banks and then sold off by them.
- 3.12. Amazingly, they used the same rating categories for sub-prime mortgages as for sovereign debt. So sophisticated investors boasted of having improved both yield and security by switching from Japanese Government bonds (AA) to an anonymous bond made up of mortgages doomed to default (AAA).
- 3.13. Unfortunately, a lot of things went wrong during the process. First, the selection of mortgages to be bundled was all too often carried out by the banks and all too rarely properly checked by the agencies. Investigations after the crash revealed many examples of agencies asking for full details of the properties to be marketed – and of those buying them – only to be told by their clients that this was either not necessary or that the information was not available. As the fees for doing the ratings were paid by the bank that would market the securities, the agencies tended to comply with their demands rather than see the business go elsewhere.
- 3.14. After the balloon had burst, a former mortgage bond analyst with S&P told a Senate Committee investigating the debacle that his managing director had not merely insisted that details of individual mortgages going into the bundles were unnecessary but also that requests for loan-level statistics were 'totally unreasonable' and that credit ratings must be produced without them.
- 3.15. No wonder a Mexican strawberry picker in California earning \$14,000 ended up with a 100 per cent mortgage on a house costing \$724,000, and an 'introductory' interest rate of 1 per cent, to be refinanced after a year at five times that. As soon as house prices stopped rising fast enough to allow refinancing of a mortgage, the roof fell in all over the country.
- 3.16. The extraordinary thing is that, within six months of the crash, the rating agencies were actually issuing downgrades on the securities of the very same banks who had lost billions by swallowing the ratings the agencies had carried out themselves.
- 3.17. Not long after that, they were threatening to downgrade bonds issued by a number of sovereign states, and more recent downgrades of Spain and Portugal injected a new risk of the contagion spreading further – to

countries struggling with the consequences of the collapse of bonds given top ratings by the agencies now set on penalising them too.

- 3.18. It is worth appreciating the background to the rating agencies because, to some extent, the fate of sterling rests in the very same hands. Fortunately, there have been moves in the last few weeks, particularly by the European Bank, to ensure that a new independent rating body is set up, and that, meanwhile, the findings of the current 'big three' are not automatically and authoritatively adopted.

Never mind the quality 3

CDOs of subprime-mortgage-backed securities
Issued in 2005-07, %

	Estimated 3-year default rate	Actual default rate
AAA	0.001	0.10
AA+	0.01	1.68
AA	0.04	8.16
AA-	0.05	12.03
A+	0.06	20.96
A	0.09	29.21
A-	0.12	36.65
BBB+	0.34	48.73
BBB	0.49	56.10
BBB-	0.88	66.67

Source: Donald MacKenzie, University of Edinburgh

This table shows the frequency with which default on sub-prime securities were expected to occur, and the rate at which they actually did.

How do we compare?

- 3.19. Commentators have been playing an amusing game pointing out how badly Britain compares with other countries in coping with the financial crisis. Thus, our Government debt is higher than Spain's or Iceland's as a proportion of GDP; our primary balance is worse than that of Greece; and we need to increase our budget balance by more than Portugal to keep our debt ratio stable at 2009 levels.
- 3.20. All this is true, but a very different picture emerges when all these elements (and others) are brought together. In Appendix 1 I set out and comment on a variety of recent graphs giving a wider picture.
- 3.21. It may be worth drawing attention here to the fact that, on the basis of its total net liabilities, the US owes over 500 per cent of its national income (against a mere 400 per cent here). A black hole to bring to the attention of the Hampshire Chronicle?
- 3.22. A further interesting finding from a recent international survey of expectations for major currencies is that Britain is regarded as the country, second only to Germany, as least likely to be forced into default on its debts. Surprisingly, the US is thought rather more at risk.

The trading outlook

- 3.23. One consistent theme of commentators and analysts is that recovery in the British economy will need to be led by exports (and an accompanying increase in investment to support the industries which sell abroad). So far there is little sign of this happening, in spite of the much-mentioned decline in the value of sterling which was looked to for the trigger.
- 3.24. While movements in foreign trade have been erratic, imports have persisted in being relatively buoyant, and although order books have been reported as growing by exporting firms, this has not yet shown up in the foreign trade figures.
- 3.25. Part of the explanation is that this country's main export markets are not, by and large, among the faster growing economies. In particular, Europe which absorbs around half of our foreign sales, is suffering from low growth – and may even underperform us in that respect for the next two or three years.
- 3.26. More seriously, while the rapid decline of the euro has gladdened the hearts of many who wished to have nothing to do with the common currency, this has been eroding much of the emerging competitive advantage we had been counting on for ourselves. It has been calculated that a 10 per cent depreciation of the euro produces a 1 per cent rise in the national income (most of which feeds through into exports) at the cost of a minimal rise in inflation.
- 3.27. If this pattern persists, it is clearly a question-mark over current projections for the UK.

4. Markets

- 4.1. There is a feeling about most markets at the moment rather like a rugby player who has suffered concussion in a tackle, but is still going through the motions, though almost completely unaware of what is happening – and a few of the spectators have yet noticed either.
- 4.2. The world is still in the throes of trying to rebalance itself: the first question is whether the global level of activity will regain pre-crash levels, and, secondly, how the gains and losses, and the pluses and minuses, will work out.
- 4.3. It seems certain that the so-called emerging world will account for a higher proportion of the future world economy, even without allowing for its more rapidly growing population. This must mean a relatively slower rate of growth in the developed world. Markets are only in the early stages of working out how this shift of emphasis will affect them.
- 4.4. When the financial storm was brewing over two years ago, there was continual reassurance, first, that the American housing market would not (even could not) prove to be a bubble, and secondly that the financial world would have little or no impact on the so-called 'real' economy.
- 4.5. History may be beginning to repeat itself, albeit in a slightly different way. The conventional signs of an economy recovering from recession can now

been seen: employment is stabilising; inventories are being (cautiously) rebuilt; and consumers are recovering a degree of confidence. Shoots that appear genuinely green are emerging everywhere.

- 4.6. But the last two years have not seen a 'normal' economic recession – more or less a pause for breath. The shattering of the financial structure and the mind-boggling trillions that have been poured in to keep the banking system from complete collapse, and the economy as a whole afloat, will take years to work their way through, and it is as yet by no means clear that a second phase of the crisis can be avoided.
- 4.7. It is almost as if the 'real world' is now in fact the mysterious subterranean arena in which finance holds sway, while the mundane activities of everyday life may prove a temporarily sunlit dream.
- 4.8. Not merely does this make activities such as optimising asset allocations difficult, since the long-term is now, more than ever, just a succession of short terms, but it also makes many current concerns seem almost trivial and irrelevant.
- 4.9. It is of course, partly a function of the selection of issues that are considered newsworthy, but the emphasis of stories coming out of the City that, yet again, there is an imminent flight of high talent to foreign cities to avoid the 50 per cent tax on the top slice of income is hardly of any real significance – particularly as it turns out that the numbers actually moving to Switzerland and other sanctuaries was lower last year than in 2008, and that salaries, after tax, remain twice as high in London.
- 4.10. Similarly, protests against the proposal to raise capital gains tax – on non-business assets – from 18 to 40 per cent is absorbing disproportionate amounts of energy and indignation. It is overlooked that it was Conservative Chancellor Nigel Lawson who, when he lowered the top rate of income tax from 60 (yes!) to 40 per cent also raised CGT to the same 40 per cent in a move which simplified the tax system and eliminated a lot of ingenious but perhaps misguided activity in dressing up income as capital. With the top rate of income tax once more higher than CGT, this industry will be given a new lease of life.

Some pointers

- 4.11. There are, however, some actions which appear prudent in considering the appropriate emphasis of an investment portfolio to respond to current and prospective conditions.
- 4.12. Most important is a geographical repositioning of equity (and possibly) other investments, notably property and infrastructure, to reflect the virtual reality that the emphasis of future growth is likely to be outside Europe – and maybe also the US.
- 4.13. This has been widely commented on in general terms over the past year or so. It has become commonplace to point out that almost half of all dividends paid on shares in the FT100 is made up by payments from BP, Shell, HSBC, Vodafone and GSK. And it is now generally recognised that around 60 per cent of the earnings of the FTSE 100 arise abroad.

- 4.14. It is perhaps not fully appreciated that dependence on export business also extends well down into the ranks of the FTSE 250.
- 4.15. I have been suggesting at Panel meetings for some time that a split of equity holdings between UK and global holdings is unsatisfactory. Even the argument that holdings with a London quotation are needed to avoid currency risk is misleading in the light of exposure of a high proportion of companies' earnings to fluctuations in the exchange rate against the currency in which they are earned. Indeed, one reason for the equity market in London being largely divorced from the trends in the UK economy is that, when sterling is weak, the share index receives a double boost: first from the translation of foreign profits at a more favourable rate, and secondly from the more competitive conditions this produces in overseas markets.
- 4.16. It would therefore be desirable to look more closely at making the split of the equity portfolios a three-way one:
- global equalities quoted abroad
 - global equalities quoted in London
 - UK equalities quoted in London
- Active / passive flavours could be added at will.
- 4.17. I have undertaken some research into the foreign sales (rather than profits) of the FTSE 100 and 250 companies and the results are set out in section 5 of this report.

Accounting for risk

- 4.18. A high priority for the fund in present circumstances must be to identify and then reduce the risks inherent in each section of the portfolio. This can take several forms – either by increasing diversification of the investments and seeking less correlation between asset classes, or/and adopting strategies which minimise specific risks through such measures as options and derivatives.
- 4.19. There are also two specific ideas which give a more positive presentation of the actual risks being run.
- 4.20. The first is to calculate the funding level in, say, five year periods instead of as a single, overall, end-figure. Providers of private annuities follow a policy of shifting the balance of a policyholder's funds towards fixed interest and other less volatile securities as they get older.
- 4.21. It may not be practicable to split the fund's holdings into physically separate 'sub-portfolios', each of which would be assigned to contributors within a given age bracket, but this could be done in nominal terms, thus showing the chances of each age group receiving its full pension entitlement on any alternative future rates of contributions.
- 4.22. Secondly, an alternative way of calculating the funding percentage of the portfolio as a whole needs to be sought.

- 4.23. The present procedure of discounting future liabilities to today's date is highly unsatisfactory, being very misleading as well as to being subject to perverse fluctuations which arise from changes in long-term interest rates – and feed uninformed criticisms of 'black holes' in the fund and doom and disaster for pensioners and council-tax payers alike.
- 4.24. The concept of all future obligations being assumed to fall due tomorrow (if not today) with no account taken of future contributions could be replaced by calculations which **start from today's assets**. Conservative assumptions as to the inflow of contributions and income and growth within the fund would be compared with the expected pensions being paid out, all at a number of future dates. The result would be compared with expected liabilities at the same dates, building in pessimistic assumptions on inflation and, if thought appropriate, longevity, although the risk of further increases in this could well be for the employees to finance if they choose to do so.

5. Globalisation of the UK equity market

- 5.1. I have been investigating the extent to which equities quoted in London are reliant on foreign business. Ideally, it would be necessary to assess the share of profits earned from exports and establish the relative size of those profits broken down by the currency in which they are earned.
- 5.2. There does not appear any established database which can immediately provide that information.
- 5.3. However, Aberdeen have provided me with tables for the FTSE 100 and 250 showing total sales of each company for their latest trading year, and, where available, the amount of foreign sales within that total.
- 5.4. I have used this raw material, which Aberdeen have not analysed in detail themselves, to produce a breakdown which should be of some assistance in assessing the extent to which London-quoted shares need to be looked at in a global as well as a domestic context.
- 5.5. The first set of four tables considers the FTSE 100. Companies are divided into five groups according to the proportion that foreign sales bear to total sales, ranging from zero through to 1-10%; 10-25%; 25-50%; 50-75% and over 75%. The second set does the same exercise for the FTSE 250.¹
- 5.6. Figures for foreign sales are not available for all companies covered by the two indices: 67 of the FTSE 100 are covered, and 140 from those in the 250. (It is, however, probable that figures for most if not all of the 'missing' companies could be obtained as part of any specific investigation which may be carried out into their accounts).
- 5.7. For many companies a breakdown of foreign sales to the US, Japan and Europe is available, although I have not embarked on this exercise.

¹ Note: Copies of these eight tables can be made available.

5.8. A summary of my calculations is set out below.

FTSE 100

Percentage of foreign sales	0	0-10	10-25	25-50	50-75	75+
No. of companies	2	8	2	9	22	24
Total sales £bn.	36.5	73.0	89.8	304.9	615.2	613.8
Foreign sales £bn.	-	4.2	18.5	110.0	367.2	506.6
Percentage		5.8	20.7	36.1	59.7	82.5

Overall share of foreign sales, excluding nil exporters: 60.6%

FTSE 250

Percentage of foreign sales	0	0-10	10-25	25-50	50-75	75+
No. of companies	23	9	13	27	24	44
Total sales £bn.	45.1	17.8	16.9	94.0	51.8	65.3
Foreign sales £bn.	-	1.2	3.5	31.3	31.8	51.6
Percentage	-	6.2	20.7	33.3	60.1	79.0

Overall share of foreign sales, excluding nil exporters: 48.6%

- 5.9. Further analysis of the FTSE 100 shows little variation in the proportion of exports to sales as turnover rises.
- 5.10. Taken as a group, the three companies with annual sales of over £100 billion (BP, Shell and HSBC) have foreign sales of 62.7% on combined turnover of £755 billion – about a third of the figure for the entire FTSE 100. The 13 companies whose sales are between £20 and £100 billion have a percentage of 68.6, and the remaining 51 companies, with sales below £20 billion, have an export proportion of 64.2%, and turnover averaging £9 billion.
- 5.11. It is possible to get some check on the remaining FTSE 100 companies. Although no overseas sales figures are available for the ‘missing’ 33, **total** sales have been identified for 27 of these. The eight between £20 and £100 billion average £38 billion – closely similar to the £41 billion for the companies for which foreign sales were obtained.
- 5.12. The 19 other companies, with total sales under £20 billion, appear rather smaller than those with identifiable export business, at an average of £5 billion as against £9 billion.

- 5.13. In summary, therefore, it can be stated with a high degree of confidence that foreign sales account for over 62 per cent of the turnover of companies in the FTSE 100 index as a whole, and for close to 50 per cent of the sales of companies making up the 250 index.
- 5.14. This demonstrates that a high proportion of exports to total sales is more predominant across British industry and commerce than is usually assumed.

6. Conclusion on globalisation of the UK equity market

- 6.1. When considering the investment merits of individual London-quoted companies, it should be part of the process to supplement this initial analysis of the pattern of sales with an estimate of the breakdown of profits as between home and overseas markets. (The two do not of course fluctuate in synchrony: for example, Tesco has very substantial sales in other continents, but these are not yet accompanied by comparable levels of profit).
- 6.2. However, if a threshold is taken of 25% of business being transacted abroad as potentially qualifying a company for inclusion in a global portfolio, although quoted in London, then this would throw up about 80 FTSE 100 companies and 160 of the FTSE components as potential candidates. (A cut-off point of over half of sales being made to foreign customers would reduce these numbers by 12 and 48 respectively).

7. Foreign sales of FTSE companies

- 7.1. The following may make an interesting footnote to my analysis of the foreign sales of FTSE 350 companies.
- 7.2. While London-quoted companies are increasingly making sales abroad, ownership of their shares is rapidly being concentrated in the hands of overseas investors.
- 7.3. The table shows changes in ownership between 1990 and as estimated in 2008.

	1990	2008
Pension funds	32	12
Insurance Companies	21	12
Other institutions	27	15
Private Individuals	12	10
Foreign	7	41

8. Investment In Tobacco Shares

- 8.1. I have analysed the impact of the current holdings of tobacco shares on the value of the fund. Their value was recently put at £46.9 million. Of this £18.6 million was in the UK equity portfolios and the balance of £28.3 million in the three global funds.

- 8.2. The UK exposure amounted to slightly over 2.3 per cent of total UK equity holdings – appreciably less than the weighting of tobacco in the UK all-share index, which is 3.6 per cent.
- 8.3. Similarly, the £28.3 million in global equity represents just under 0.3 per cent of the value of the three portfolios. The weight given to tobacco in the MSCI world index is 0.8 per cent, whereas the total investment in all five Hampshire portfolios is just 0.26 per cent.

Trends

- 8.4. It is difficult to measure the contribution of tobacco to the overall progress of the equity funds over time, partly because of the continuing inflow of new money and retained dividends. I have therefore made what I call a ‘semi-synthetic’ calculation assuming that the current holdings had actually been in the various portfolios since the beginning of 2008.
- 8.5. Changes in key indicators since then are summarised below.

	January 2008	End May 2010	
FTSE 100	6,417	5,163	-19.5%
S&P 500	1,447	1,071	-26.0%
Nikkei 225	15,156	9,712	-36.0%
Exchange Rate \$ to £	1.96	1.47	-25.0%
Y to £	217.3	134.2	-38.2%

- 8.6. The FTSE 100 has been chosen as the yardstick as it includes both major UK tobacco manufacturers. (All the firms in which the fund has holdings appear in the 500 largest companies in the world in terms of market cap.)
- 8.7. Over the period from January 2008 to the latest portfolio valuation, the UK holdings recorded an increase of around 8.5 per cent, or £1.5 million. The overseas shares fared rather worse in terms of local currencies (dollar and yen). A precise calculation is complicated by changes in the capital structure of the former Philip Morris, but a generous estimate would be that they broke even. While there was a windfall on currency rates due to the fall in sterling (of over £3.5 million) that would of course arise on any investment in those currencies. Dividend income is estimated at just over £3 million p.a. (4.3%).

Conclusion on tobacco shares

- 8.8. The small gain in the overall value of the holdings (and the dividend return which is above the 3.3 per cent on the FTSE 100) compare well with the falls in the relevant share indices set out above. Tobacco has therefore proved to be a useful defensive investment.

- 8.9. It should be noted that the precise figures would be altered by making different assumptions as to the timing of the original investments, but the broad picture remains unaltered.

9. Recommendation

- 9.1. That the report be noted

CORPORATE OR LEGAL INFORMATION:**Links to the Corporate Strategy**

Hampshire safer and more secure for all:	yes/no
Corporate Business plan link number (if appropriate):	
Maximising well-being:	yes/no
Corporate Business plan link number (if appropriate):	
Enhancing our quality of place:	yes/no
Corporate Business plan link number (if appropriate):	
OR	
This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision because actions are required concerning the actuarial valuation of the Hampshire Pension Fund.	

Other Significant Links

Links to previous Member decisions:		
<u>Title</u>	<u>Reference</u>	<u>Date</u>
Direct links to specific legislation or Government Directives		
<u>Title</u>	<u>Date</u>	

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

<u>Document</u>	<u>Location</u>
None	

IMPACT ASSESSMENTS:

1. Equalities Impact Assessment:

- 1.1 Equality objectives are not considered to be adversely affected by the proposals in this report.

2. Impact on Crime and Disorder:

- 2.1 The proposals in this report are not considered to have any direct impact on the prevention of crime.

3. Climate Change:

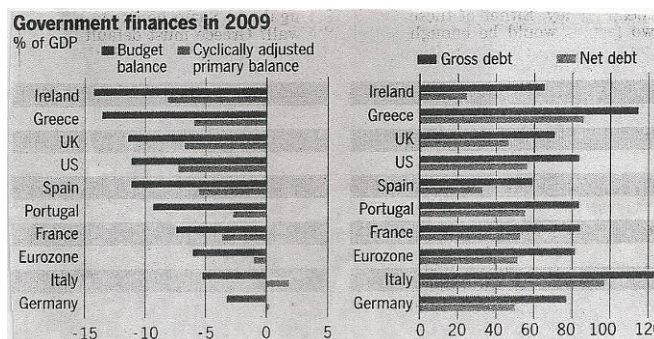
- a) How does what is being proposed impact on our carbon footprint / energy consumption?

No specific impact.

- b) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

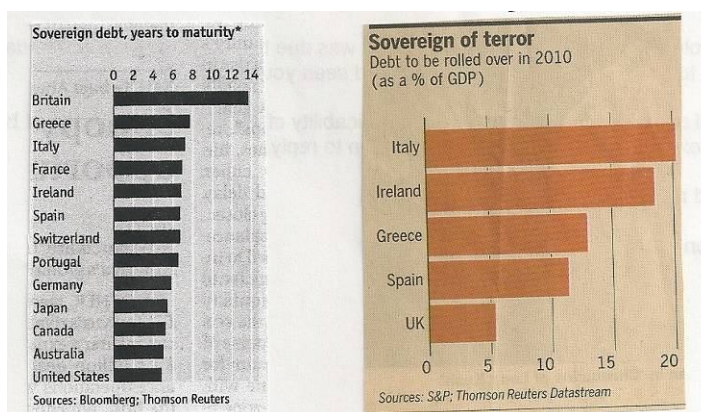
No specific impact.

Comparative comparisons

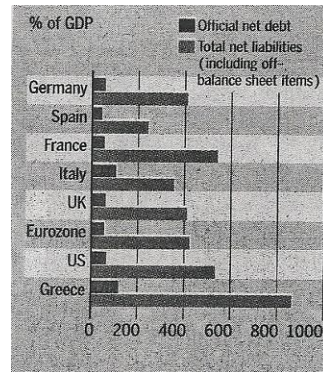


National debt is usually stated in terms of the ratio of borrowing by the government to GDP. Thus, the UK appears with a figure of almost 70% above. This falls to around 43% on a net basis, bringing in state-owned assets. This is about the same as Germany, and less than the US and France, although higher than Ireland and Spain.

On the left hand side of the chart the gap between the balance of national budgets and the underlying primary, or structural position is illustrated. Italy, surprisingly, shows a surplus and Germany is cyclically in balance. The others, except Ireland, have a broadly similar gap between their actual and cyclically adjusted primary balances, with the UK and US in virtually the same situation.

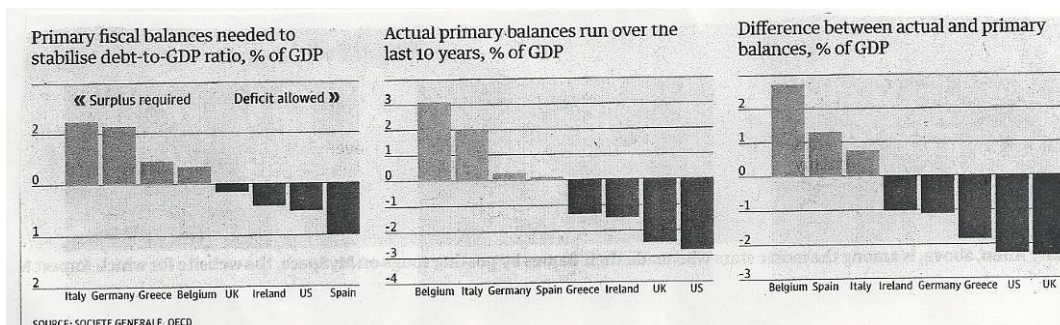


As well as the size of national borrowing the average length of the loans outstanding is important. The left hand chart shows that Britain's debt has three times the maturity of all the other countries – with Greece, perhaps surprisingly, in second place. This reduces pressure for refinancing – which can arise at embarrassing moments. The point is emphasised in the chart on the right: Britain has to roll over only 5% of its borrowing this year. Compare Greece at over 12 per cent (and Italy at 20% of GDP).



Government debt is usually stated as the gross amount that is owed. But the public sector also has assets – e.g., the shareholdings in RBS and Lloyds. Taking the two together, Germany has a positive balance; Britain is almost in balance; Greece sees its position improved in terms of GDP. Portugal is shown to be the only country with a private negative position to add to its state indebtedness.

On the right all of a country's liabilities are brought into the picture, including long-term (often unfunded) obligations such as pensions and health insurance schemes. Spain is the only country with obligations less than 2.5 times current national level.



A distinction is drawn between the primary and total balance of national accounts. Primary balance reflects the underlying, or structural, position, i.e., after eliminating the effect of temporary factors. The chart above shows the scale of the adjustment necessary to restore various countries' balance to a stable percentage of GDP. Britain has 'used up' nearly all its allowance and has to make the largest adjustment.

(NB the countries are shown in descending order in each of the three charts, and this is different in each case).

On this measure, Germany has a relatively large adjustment to make – and Spain and Italy have elbow room in hand.

Country	Rating S&P rating	Yield on 10-year bonds (%)	CDS Five-year sovereign debt (basis points)	Debt Servicing Interest payments as a % of govt revenue, 2011*	Debt levels Gross debt as a % of GDP, 2011*	Maturity Average maturity of govt debt (years)
Germany	AAA	3.14	44	6.2	85.5	5.8
US	AAA	3.65	46	7.4	99.5	4.8
France	AAA	3.44	61	6.1	99.2	6.9
UK	AAA	4.07	91	8.7	94.1	13.7
Japan	AA	1.31	75	4.5	204.3	5.4
Italy	A+	4.03	136	11.0	129.7	7.2
Portugal	A+	4.59	181	7.9	97.2	6.5

Sources: S&P; OECD; Thomson Reuters * OECD forecasts

The current ratings of Government bonds cover three grades, from AAA down to A+. On the standards adopted by the rating agencies, the UK appears to be near the edge of AAA, with a higher yield on its bonds and debt servicing costs higher than all except Portugal. But its debt/GDP ratio is second lowest, to Germany, and as previously mentioned, average maturity of debt is very much longer.