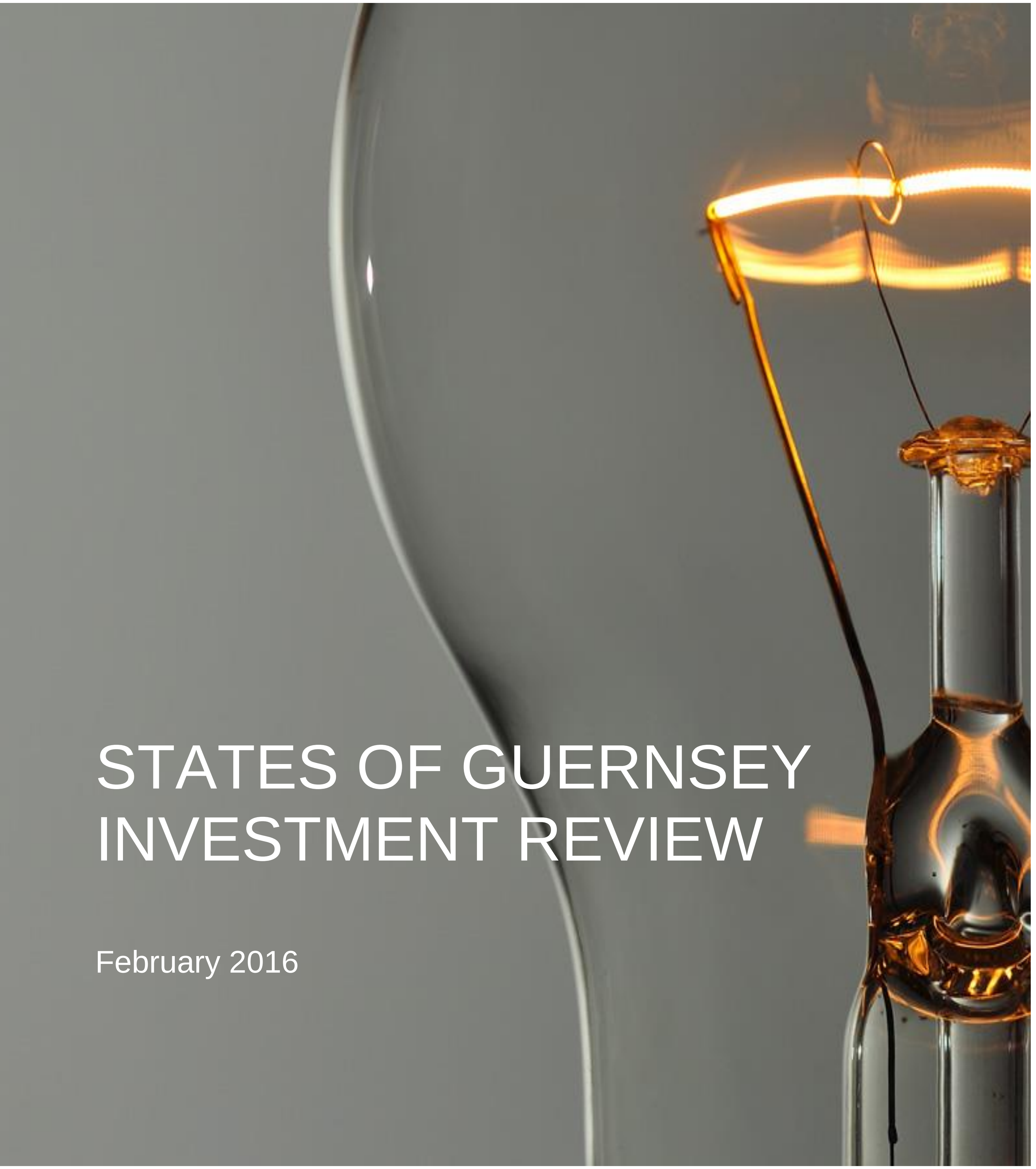

STATES OF GUERNSEY INVESTMENT REVIEW

February 2016

BDO

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Public Accounts Committee
The States of Guernsey
Sir Charles Frossard House
La Charroterie
St Peter Port
Guernsey
GY1 1FH

16 February 2016

Dear Sirs

In accordance with your instructions, confirmed in our agreement dated 11 November 2015 ("the Agreement"), we have prepared this report following our review of the investments of the States of Guernsey. This report is addressed to and intended for the use of the addressee only and, save as expressly provided for in the Agreement, it is not to be referred to or quoted, in whole or in part, in any other context without our prior written consent.

This report is based on the latest information made available to us as at the completion of our work on 16 February 2016 and we have not updated our work since that date. We accept no responsibility to update it for events that take place after the date of its issue.

We prepared this report from information supplied by, and from discussions with, the individuals and firms listed at the start of sections 2 and 3 of this report. Except where specifically stated in the report, we have not verified the accuracy, reliability or completeness of the information supplied and the procedures that we used to perform the work did not constitute an audit or review made under any generally accepted auditing standards. Section 1 of this report is a summary of key findings only. The body of the report contains key advice and issues that may not have been captured in the summary of key findings and, accordingly, BDO accepts no responsibility for any reliance placed on the summary of key findings only.

We thank you for affording BDO and Broadstone the opportunity to assist you in this engagement.

Yours faithfully
For BDO Limited

For Broadstone Limited

Richard Searle
Managing Director

Peter Dean
Investment Consultant

1. EXECUTIVE SUMMARY

1.1 Introduction

The States of Guernsey holds substantial investment funds which total in excess of £2bn. These are controlled by two States Departments, the Treasury and Resources ("T&R") Department and the Social Security Department ("SSD").

The T&R Department is mandated to manage financial assets which include:

Fund	Value 31/12/2014 £'m
Superannuation Fund	1,135
Core Investment Reserve	143
Capital Reserve	111
Notes and Coins Reserve	47

Source: States of Guernsey Accounts 2014

During 2014/2015 the investment strategy was amended so that all of the above T&R funds are invested in one or more common funds comprising the Short Term Treasury, Medium Term Investment Reserve and the Long Term Investment Reserve. The latest available values for these funds at 31 October 2015 were:

Fund	Value 31/12/2014 £'m
Long-term Investment Reserve	1,438
Medium-term Investment Reserve	296
Short-term Treasury	141

Source: IAM Advisory Monthly Report – October 2015

The SSD has specific responsibility for the following Funds:

- Guernsey Insurance Fund
- Guernsey Health Service Fund
- Long Term Care Insurance Fund

All SSD funds are invested in the Common Investment Fund ("CIF") which was valued at £790m at 30 September 2015 (Source: P-Solve Investment Governance Report Q3 2015).

1.2 Scope of Work

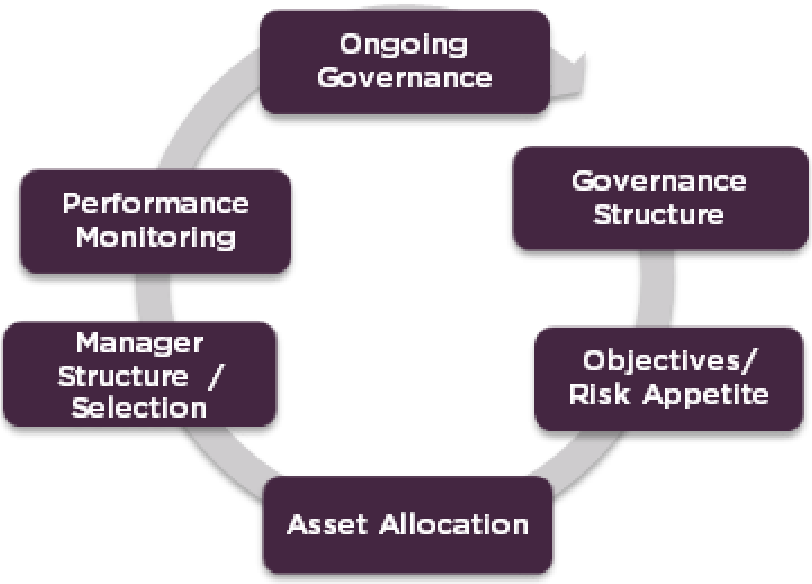
The Public Accounts Committee ("The Committee") requested BDO examine the current performance of the funds invested whereby the following areas should be specifically considered:

- The total funds invested by the States
- Whether returns might be improved by alternative management structures
- The effectiveness of the existing arrangements in delivering the States' objectives
- The process for assessing risk, liquidity and benchmarking

This report considers whether the States is investing funds safely and securely, whilst maximising returns for appropriate levels of risk.

In the tender document BDO explained that the review would be conducted at a high level examining the appropriateness of the overall investment strategy, risk levels and objectives and therefore would not look at the underlying performance of funds, stocks or managers.

In carrying out our review of funds under the control of both the Treasury and Resources Department and the Social Security Department, we have examined key aspects that would typically be addressed throughout an investment strategy review cycle as follows:



In preparing this review, we have used the services of Broadstone Corporate Benefits Limited, a member firm of the BDO Network, which specialises in the provision of investment consulting.

1.2 Key Findings

We believe that the assets of the States of Guernsey are invested safely and securely, and that the overall risk and return characteristics of the assets are appropriate. We also believe that the current manager structures are appropriate and give appropriate effect to delivering the States' objectives.

However, during the course of our review we have identified a number of areas for potential review:

Areas for potential review	Department
1. We recommend that consideration be given to: • Making the Investment Sub-Committees of both the Treasury and Resources Department and the Social Security Department permanent bodies • Increasing the role of non-elected members to have voting powers • Increasing the number and role of non-States / executive members on the Boards • Ensuring that newly elected members of the Investment Sub-Committees undertake a formal investment training needs analysis and appropriate training within six months of their appointment.	T&R Department / SSD
2. We recommend that the Treasury & Resources Investment Sub-Committee pays greater attention to managing and contracting with external advisers. In particular, there should be put in place a regular framework for reviewing the performance of the existing Investment Consultant in line with best practice. It should be emphasised that we are not in any way suggesting that a change is necessary.	T&R Department
3. We believe that the long term return target for the Long-term Investment Reserve and the Medium-term reserve should be reviewed as we believe the existing return targets of UK RPI plus 4.0% and 3.5% respectively are challenging.	T&R Department
4. We recommend that the investment objectives for the Common Investment Fund be reviewed and clarified.	SSD
5. We recommend that the T&R Investment Sub-Committee considers the risks of the investment strategy in relation to the liabilities of the Superannuation Fund. In particular the Investment Sub-Committee should consider the impact of interest rate and inflation on the funding of the Scheme and the extent (if any) to which they would wish to hedge these risks.	T&R Department
6. We recommend that the Investment Sub-Committee works with the investment manager and Consultant to understand the possible impact on liquidity under various scenarios, particularly in relation to the Medium Term Investment Reserve and the Treasury Fund.	T&R Department
7. We recommend that the T&R Department Investment Sub-Committee considers more formally identifying and documenting the risks within each investment reserve and the steps taken to mitigate these risks. This has been carried out for the SSD CIF.	T&R Department
8. We recommend that the impact of transaction and other fees is included in the formal review of fees and that the T&R Department considers managers used by the SSD when considering any changes to managers (and vice versa).	T&R Department/ SSD
9. We recommend that a periodic review of fees be undertaken to ensure that they remain appropriate and competitive,	SSD
10. We recommend that the Investment Sub-Committee considers preparing and maintaining a Governance Framework Document for the T&R Department on a	T&R Department

Areas for potential review	Department
similar basis to the document prepared by the Social Security Department.	
11. We recommend that any existing or potential conflicts of interest are disclosed at the beginning of each meeting of both T&R Department and SSD Investment Sub-Committees and recorded in the minutes.	T&R Department / SSD
12. We recommend that the T&R Department Investment Sub-Committee follows best practice guidance in implementing a forward looking investment business plan and evaluating progress against this on a regular basis. This is in place under the SSD CIF.	T&R Department
13. We recommend that the T&R Investment Sub-Committee: • Reviews and publishes their policies regarding responsible ownership. • Considers the potential for investment managers to add value through actively engaging with the companies in which they invest when formulating investment strategy and selecting investment managers. • Ensures that investment managers have an explicit strategy, setting out the circumstances in which the investment managers will intervene in a company. • Takes into account their investment managers' statements on compliance with the UK Stewardship Code and whether they are signatories to the United Nations Principles for Responsible Investment (UNPRI) when evaluating and selecting managers.	T&R Department
14. We recommend that the SSD CIF's position on responsible investments be made public.	SSD
15. We recommend that the internal resources available to manage the investments of the SSD should be reviewed. We recommend that consideration be given to cross-departmental support with the Treasury and Resources Department.	SSD / T&R Department
16. Given that the two investment consultants are independent of one another, consideration may be given to them each reviewing the others' recommendations on significant changes to the investment strategy before any final decisions are implemented. This would add an additional layer of oversight.	T&R Department/ SSD

We believe the liaison between the Investment Sub-Committees of both Departments has been positive and should be further encouraged. We generally do not support the use of a single Investment Consultant across both Departments and we do not support the idea of introducing peer group comparisons.

We would like to thank the representatives of both Departments and their investment consultants for their time and co-operation.

2. TREASURY AND RESOURCES DEPARTMENT

The Treasury and Resource (T&R) Department has responsibility for investing and managing all States' Funds except those managed by the Social Security Department.

We met with the following representatives on 10 December 2015:

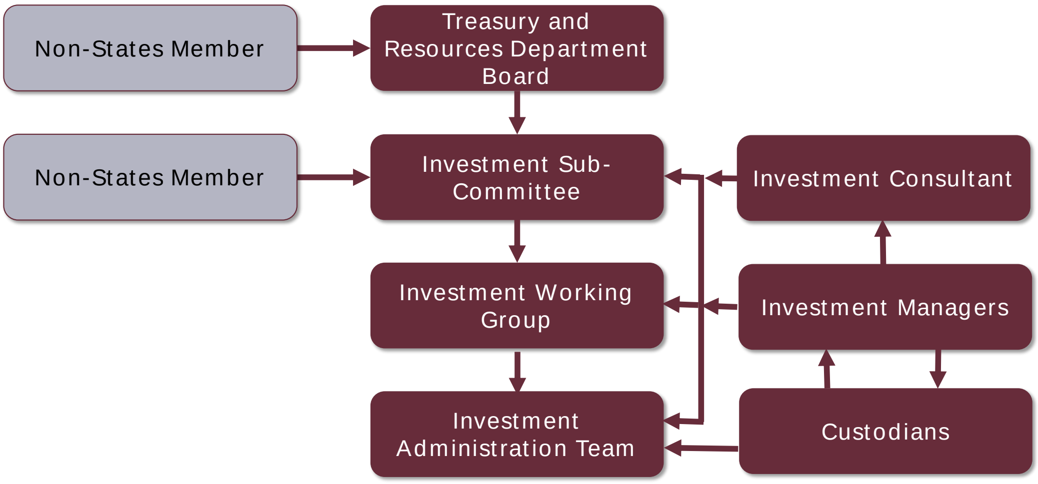
- Bethan Haines - States Treasurer
- Liz Stonebridge – T&R Department Investments Manager
- Michael Strachan - Investment Consultant – IAM Advisory
- Simon Bowden – IAM Advisory

This was followed up with a separate meeting with IAM Advisory on 17 December 2015.

Further information and correspondence was provided and has formed the basis of this review.

2.1 Current Structure

The T&R Board currently retains overall responsibility for the investments. The T&R Board is made up of five elected politicians. Various investment activities are currently delegated as shown below:



2.1.1. Treasury and Resources Department Board

The T&R Board is made up as follows:

Deputy Gavin St Pier*
Deputy Jan Kuttelwascher
Deputy Roger Perrot*
Deputy Hunter Adam*
Deputy Anthony Spruce
Mr John Hollis (non-States member)

** Investment Sub-Committee Members*

The T&R Department Board members serve a four year term and there is no guarantee of continuity beyond the end of each term. The next election is due to take place in April 2016.

2.1.2. Investment Sub-Committee

The T&R Department Board retains overall discretion as to whether to operate an investment sub-committee and will decide on which activities are delegated.

The Investment Sub-Committee ("ISC") comprises three Committee Members and one Non-States/non-voting Member (currently Chris Waldron). The Minister is always on the ISC. Other ISC members are selected based on their knowledge and experience of investments.

The ISC's current mandate includes:

1. Monitoring the performance of the investment managers.
2. Managing tender exercises for services provided and making recommendations to the Board on appointments.
3. Recommending to the T&R Board any changes required to the investment policies.
4. Reviewing the investment strategy.
5. Reviewing and recommending to the Board any changes to the investment mandates.
6. Developing closer working arrangements with the Social Security Department on their investments and exploring ways of more effective use of resources.
7. Considering the investment policy following the results of the tri-annual actuarial review of the Superannuation Fund.

ISC Meetings are attended by the States Treasurer, Investment Consultant and the Investments Manager. Members of the Social Security Department Investment Sub-Committee are also invited to attend on a reciprocal basis.

The ISC also meets with each of the investment managers on an annual basis.

The relatively recent appointment of Non-States Member Chris Waldron has added to the experience of the Sub-Committee, and provides some continuity in the event of changes in States Members. We have not considered the level of remuneration for Non-States Members.

The ISC meets on a monthly basis to discuss investment matters.

There is a lack of continuity amongst the members of the ISC and there is no clear way in which this can be addressed without impacting on the broader political structure. Furthermore, the ISC should have sufficient expertise to be able to evaluate and challenge the advice they receive, and manage conflicts of interest.

We recommend that consideration be given to:

- Making the ISC a permanent body
- Increasing the role of non-elected members to have voting powers
- Increasing the number and role of non-states / executive members of the Board
- Ensuring that newly elected members of the ISC undertake a formal investment training needs analysis and appropriate training within six months of their appointment.

We have separately recommended that conflicts of interest within the ISC and more broadly, be declared.

2.1.3. Investment Working Group

The Investment Working Group comprises the States Treasurer, Investments Manager and the Investment Consultant. The role of the Working group is to:

- Analyse and propose to the ISC alternative investment risk/return objectives.
- Analyse and propose investment strategy.
- Analyse and propose the structure of investment mandates.
- Review and propose the appointment/ removal of investment managers and custodian.
- Review and monitor performance (monthly) and propose action if necessary.
- Review and propose governance procedures.
- Discuss personnel and institutional changes.

The Investment Managers have delegated authority to manage the allocation of assets in their portfolio in accordance with the permitted investment rules stipulated in their Investment Management Agreements. The Investment Manager liaises with the team who undertake daily banking reconciliations to ensure that there are sufficient balances in the short-term reserve to meet cash-flow requirements.

2.1.4. Investment Consultant

The Investment Consultant advises on the strategic asset allocation, manager structure, manager selection and risk controls of the Medium Term and Long-term Investment Reserves taking into account the States Rules for Financial and Resource Management and the Permitted Investment Rules.

The Investment Consultant is responsible for:

- Analysing and proposing investment risk/return objectives for each manager.
- Analysing and proposing the investment strategy.
- Analysing and proposing structure on investment mandates.
- Reviewing and proposing the appointment and removal of investment managers.
- Reporting and monitoring the performance at all levels (objectives, strategy, structure, individual mandates).
- Supporting the Investments Manager with operational management of the investment programme.

The Investment Consultant also undertakes a training needs analysis for all ISC members and provides additional training as required.

IAM Advisory was appointed to provide investment consultancy services in respect of the Contingency Reserve Fund on 1 May 2007 and the Superannuation Fund on 4 November 2008. IAM Advisory ~~are~~ is based in Guernsey and also has offices in London and Jersey. Michael Strachan is the Lead Consultant and he is supported by Simon Bowden. IAM Advisory attends monthly meetings and has a close working relationship with the T&R Department.

We have noted that due to the current structure of the Investment Sub-Committee and the resources available within the Treasury and Resources Department, heavy reliance is placed on the existing Investment Consultant with whom a strong working relationship has developed.

We understand that there appears to have been no formal review of IAM Advisory's appointment. Whilst we have no particular concerns regarding the existing Investment Consultant, it is good practice to review the appointment formally on a periodic basis, even if this process concludes that no change is necessary.

The appointment of investment managers is largely driven by the mandate provided, their performance and the advice received from the Investment Consultant.

> **We recommend that the Investment Sub-Committee pays closer attention to managing and contracting with external advisers (including advice on strategic asset allocation, and investment management).**

2.1.5. Custody Services

Northern Trust currently provides custody services for the Long-term Reserve, Medium-term Reserve and Treasury funds. Where pooled funds are used, the investment manager will appoint the custodian. In such cases, Northern Trust provides custody services for the units in funds on behalf of the Department.

The Custodian maintains the security of all the financial assets and is responsible for:

- Ensuring the accuracy of accounting records, with at least monthly complete reconciliations of investment managers accounts
- Executing all transactions in an efficient and cost effective manner
- Managing operational aspects efficiently in conjunction with investment managers
- Providing additional services and support as requested by the Investments Manager
- Reclaiming tax under Sovereign Immunity where appropriate

Past issues arising with the collateral pool during 2008/2009 have been resolved and the extent of stock lending has reduced substantially from the levels seen at that time.

The Investment Working Group continues to work closely with the custodian to ensure any tax that is due is reclaimed under Sovereign Immunity. We have not examined in detail the effectiveness of this. We have also not examined the extent to which the different treatment of Sovereign Immunity in different countries could impact on investment returns. We believe that this is likely to affect only a limited number of markets, mostly emerging.

We understand that consideration is being given to the appointment of Northern Trust Guernsey rather than London. We have no concerns over this proposed change.

2.2 Current Objectives and Risk Appetite

The States of Guernsey seeks the maximum return on its investments within agreed levels of risk and the Permitted Investment Rules. In examining the current risk and return objectives, we have assumed that these are reflected net of all fees and have ignored transaction costs.. We have also ignored any potential gains from active management as this reflects standard practice, and of course it is difficult to agree on the extent (if any) to which active management adds value, net of fees, over the longer term.

2.2.1. Long-term Investment Reserve

Investment Return Objective

The current investment return objective for the Long-term Investment Reserve is to target a real return of 4% above UK inflation over the long term.

The States assets invested in the Long-term Investment Reserve comprise the following:

Fund
Superannuation Fund
Bond Reserve*
Core Investment Reserve
Notes and Coins Reserve

* The Bond Reserve assets are split between the Long-term Investment Reserve and the Medium Term Reserve

Approximately 80% of the assets held in the Long-term Investment Reserve relate to the Superannuation Fund. Therefore the long term expected return objective for the Long-term Investment Reserve will have a significant impact on the assumptions used to determine the funding strategy for the Superannuation Fund. It has not been made clear during our discussions, whether the investment return target for the Long-term Investment Reserve is driven by the agreed assumptions used to set the funding objectives of the Superannuation Fund, or the other way around.

The Superannuation Fund valuation model currently uses a discount rate of UK RPI plus 3.25% with the difference between this and the investment return target of UK RPI plus 4% reflecting a margin for prudence. We understand that this has remained unchanged from the previous valuation conducted as at 31 December 2010.

Based on the assumed inflation rate of 3.6% p.a. at the last actuarial valuation, the nominal expected return for the assets was 7.6% p.a. (6.85% p.a. taking into account a margin for prudence).

This compares to an average nominal discount rate of 4.45% p.a. used by UK pension schemes over the period 22 September 2012 – 22 September 2013 (the latest available data) that invested 80% or more in return seeking assets. The 95th percentile nominal discount rate for all UK pension schemes over this period was 5.01%. In general, there has been a decline in investment return expectations since then.

The Jersey Teachers' Superannuation Fund and the Jersey Public Employees Contributory Scheme invest 90% of their assets in growth assets and 10% in bond-like assets. This asset allocation is not dissimilar to that currently adopted by the States of Guernsey, and therefore it is informative to examine the discount rates used to value the liabilities of both schemes.

The Jersey Teachers' Superannuation Fund actuarial valuation as at 31 December 2013 assumed a rate of return of 3.5% p.a. above UK RPI (with no margin for prudence) and this was considered at the top end of the range of reasonable assumptions. The Jersey Public Employees Contributory Scheme valuation at the same date used a blended rate which equated to 2.7% above the UK RPI.

We have compared the current asset allocation to the expected Sterling returns published by JP Morgan (2016 Capital Market Return Assumptions) and derived a nominal long term expected return for the Long-term Investment Reserve of approximately 5.7% p.a.

JP Morgan's Capital Market Assumptions also assumes a long term rate of inflation for the UK of 2.25% resulting in a return above inflation of 3.45% p.a.

Asset Class	JP Morgan Capital Market Assumptions 2016	Long Term Compounded Return (p.a.)	Illustrative Asset Allocation
Multi-Asset	AC World less 0.5% p.a.*	5.5%	48.0%
International Equity	AC World Equity	6.0%	17.5%
Emerging Markets	Emerging Markets Equity	8.5%	10.0%
Fixed Interest	45% World Government Bonds/ 45% US Investment Grade Hedged/ 10% High Yield	3.4%	9.0%
Property	European Direct Real Estate	5.0%	12.0%
Private Equity	Private Equity	7.0%	3.5%
Total Long Term Expected Return		5.7%	100%
Total Long Term Expected Return above UK inflation		3.5%	100%

*We have made a very broad assumption that the Multi-Asset managers earn 0.5% below equities. If it is assumed that the multi-asset managers earn equity returns, the increase in the expected return of the total portfolio is only an additional 0.2% over the long term.

We appreciate that there is considerable uncertainty around the long term expected return for this portfolio and the longer term effects of currency hedging. Indeed, Broadstone's own long term return assumptions result in an expected return for the portfolio of 3.0% p.a. above inflation. In addition, it could be argued that the JP Morgan Capital Market Assumptions only apply over the next ten years and that longer term assumptions may differ.

Active management of a large part of the assets is expected to generate additional outperformance over time. However it would be unusual to take into account this outperformance when deciding on a suitable investment return objective.

In June 2015, IAM Advisory reported that they believed that the current investment return objective remained achievable and appropriate. In our discussions with IAM Advisory, their view was that they are guided by the investment managers, who they have said continue to believe that an investment return target of RPI plus 4% is achievable.

> **Based on a review of a number of published long term return assumptions, we believe that the current long term return target of 4% above inflation is challenging and would recommend that this be reviewed.**

The Long-term Investment Reserve also has a secondary objective of achieving an above average return relative to the universe of returns achievable under the guidelines over a rolling 5 year period. We believe that this is an appropriate secondary objective which is described more fully in Section 2.5 of this report.

Investment Risk Objective

IAM Advisory has assisted the Investment Sub-Committee in assessing and determining the level of risk within the portfolio. IAM Advisory undertook a detailed analysis of the risk and return profile for a large number of alternative investment portfolios with various asset allocations and constraints.

IAM Advisory uses a proprietary program that provides this risk analysis which, together with discussions held with the Investment Sub-Committee, enabled the initial broad investment guidelines to be determined.

In late 2008 IAM Advisory developed a risk profile appropriate to the Superannuation Fund based on a one year Value at Risk of 10% with a 5% level of probability as the primary measure.

IAM Advisory provided a detailed report in June 2015 examining the historic levels of risk within the portfolio. This analysis confirms that the volatility of the Superannuation Fund has been approximately half that of world equity markets. The historical Value at Risk since November 2008 has been 3.05%.

Risk should also be considered in ways other than statistical analysis, particularly with certain asset classes, such as private equity. IAM Advisory's proprietary software is reliant on being able to obtain details of marketable securities and does not, for example, allow for private equity to be modelled.

However IAM Advisory has provided the Investment Sub-Committee with details of the risks of investing in this asset class and more generally has provided the Investment Sub-Committee with details of other sources of risk within the portfolio. This information should be collated and recorded in an appropriate document.

> **We recommend that the Investment Sub-Committee considers more formally identifying and documenting the risks within their investment strategy and the steps taken to mitigate these risks.**

As stated above, approximately 80% of the assets of the Long-term Investment Reserve relate to the Superannuation Fund. The lowest risk investment strategy for these assets would be a portfolio of suitable bonds, chosen so that the projected income from these bonds would match the profile and term of the projected benefit outgoings. However, the States of Guernsey has implicitly taken on additional risk by investing in other assets (such as equities, property etc.), with the aim of achieving higher returns over the long term.

As a result, the liabilities of the Superannuation Fund are extremely sensitive to changes in the discount rate. A 0.25% reduction in the discount rate results in a decrease in the funding level of 3.4% (approximately £33m). Whilst a reduction in inflation will reduce the discount rate, this would be partially offset by a reduction in the value of the liabilities as lower inflation will result in lower salary and benefit increases. Importantly, funding volatility could impact the contribution requirements at each valuation.

Over the period since 1 January 2000, 20 year implied inflation has ranged between 2.3% p.a. and 4.1% p.a. We consider inflation an unrewarded risk over the long term i.e. we do not expect the States to be rewarded for taking inflation risk over the long term. In setting and reviewing their investment strategy, the ISC should take account of the form and structure of liabilities. It is noted that all current risk calculation are carried out on an absolute basis and not relative to the liabilities of the Superannuation Fund.

We recommend that the T&R Investment Sub-Committee considers the risks of the investment strategy in relation to the liabilities of the Superannuation Fund. In particular the Investment Sub-Committee should consider the impact of interest rates and inflation on the funding of the Scheme and the extent (if any) to which they would wish to hedge these risks.

2.2.2. The Medium Term Reserve

Investment Return Objective

The current investment return objective for the Medium Term Reserve is to target a real return of 3.5% above UK inflation over the longer term. There is no definition of what the length of the 'medium term' is.

The States assets invested in the Medium Term Reserve comprise the following:

Fund	Fund
Corporate Housing Programme	Higher Education Loans Fund
Transformation and Transition Fund	Health and Social Services Accommodation Fund
Insurance Deductible Fund	Channel Islands Lottery (Guernsey) Fund
Economic Development Fund	Sports Loans Fund
Solid Waste Trading Account	Capital Reserve
Wilfred Carey Purchase Fund	Bond Reserve

* The Bond Reserve assets are split between the Long-term Investment Reserve and the Medium Term Reserve

Instead of determining a risk/return profile for each of these Funds, the T&R Department has aggregated the short term cash flow requirements for each Fund to form the Treasury Pool and the balance is considered suitable for the Medium-term Investment Reserve.

We have compared the current asset allocation to the expected Sterling returns published by JP Morgan and derived a nominal long term expected return for the Medium Term Reserve of approximately 5.1% p.a.

Asset Class	JP Morgan Capital Market Assumptions 2016	Long Term Compounded Return (per annum)	Illustrative Asset Allocation
International Equity	AC World Equity	6.0%	40.0%
Bonds	50% US Aggregate Bonds Hedged / 50% Euro Aggregate Bonds Hedged	3.4%	40.0%
Emerging Markets Credit	Emerging Markets Corporate Bonds Hedged	6.5%	10.0%
High Yield	US High Yield Hedged	6.7%	10.0%
Total Expected Return		**5.1%**	**100.0%**

Based on JP Morgan's long term expected rate of inflation for the UK of 2.25% the resulting return above inflation is 2.8% p.a.

Taking into account the need to invest in lower risk assets and to maintain an appropriate degree of liquidity, we believe that the investment objective of 3.5% above UK RPI inflation is challenging and should be reviewed.

The Medium Term Reserve performance objective of UK RPI plus 3.5% is measured over a rolling five year period. There is also a secondary objective of achieving an above average return relative to the universe of returns achievable under the guidelines over a rolling 5 year period.

Investment Risk Objective

We understand that IAM Advisory has undertaken a detailed investment risk analysis on the same basis as the Long-term Investment Reserve. However there appear to be no specific risk objectives relating to the Medium Term Reserve.

Three year risk statistics are included within the regular monthly reporting, which includes risk relative to the Lipper Global Mixed asset GBP Conservative Index. In our view this index provides a reasonable benchmark given the asset allocation of the Medium Term Reserve.

IAM Advisory's 'Portfolio Risk' report dated June 2015 examined the historic levels of risk within the portfolio. This analysis confirms that the volatility of the General Investment Pool had been maintained at a low level relative to the opportunity set since inception in November 2007 and the historical 95% Value at Risk since August 2004 has been 1.64%.

We would recommend that the Investment Sub-Committee documents the investment risks within the Medium Term Reserve and the steps taken to mitigate these risks. This includes governance risk, financial exposure risks, performance risks, operational risk etc.

2.2.3. Treasury Pool

Investment Return Objective

The Treasury Pool has an absolute return objective of UK BBA 3 month LIBID plus 0.25% and a relative return objective of above average returns relative to the universe of returns achievable under the guidelines.

The investment return objective suggests that a large proportion of the fund will need to be placed in longer maturity or less liquid assets. For example, spreads on 1-3 year AA rated corporate bonds have varied between 0.4% and 0.9% over the last two years. In addition, with yields being particularly low, the investment manager will need to work harder to generate sufficient returns to cover fees and costs.

Investment Risk Objective

There is no specific risk objective although various constraints within the portfolio guidelines implicitly reflect the investment risk objectives. These include asset class, institutional and credit limits, currency exposure and limits in any one stock or fund. The Investment Guidelines prescribe that a minimum of £50m of the fund must be able to be liquidated within 5 days. This represented approximately 35% of the portfolio value at 31 October 2015.

Whilst this is an important measure of liquidity, this does not adequately address the risks involved in liquidating the portfolio within that time frame. For example the spread costs of liquidating assets can become much higher in times of market stress. There has been considerable speculation in the financial press around the liquidity of bond funds that could be held in the Treasury Pool and the Medium-term Investment Reserve.

We recommend that the Investment Sub-Committee works with the investment manager and Consultant to understand the possible impact on liquidity under various scenarios for both the Treasury Pool and the Medium-term Investment Reserve.

The allocation limits are considered in more detail in the next Section.

2.3 Asset Allocation

The States' Rules for the financial management have been prepared by the T&R Department in accordance with its mandate, which includes the allocation and administration of all the States' resources and the regulation and control of the States' financial affairs. The investment of assets is subject to the States of Guernsey overriding investment rules as set out by States' Resolution.

The Permitted Investment Rules allow for a wide range of investments in bonds, equities, property, derivatives and pooled funds. The Permitted Investment Rules were last amended in 2015 to allow explicitly up to 10% of assets to be held in investments focused on corporate entities where the majority of their revenue is derived from undertakings in Guernsey.

The T&R ISC approves investment guidelines at both the total fund and manager level. The Investment Working Group sets detailed investment guidelines, monitors the investment managers and resolves day-to-day interpretation of the guidelines.

2.3.1 Long-term Investment Reserve

The asset allocation for the Long-Term Investment reserve has been determined using IAM Advisory's proprietary software (Active Management Performance Standards) which simulates a wide range of possible 'opportunity sets' based on historical data to determine suitable guidelines that reflect the desired risk and return characteristics of the portfolio.

We have had discussions with IAM Advisory regarding the detail of how their asset allocation process is modelled and we believe that the framework is robust and appropriate. However, like many models, the framework is dependent on using market indices to determine the 'opportunity set', and this may not capture all risks. In addition, any allocation to non-marketable investments, such as private equity, will require an element of subjectivity.

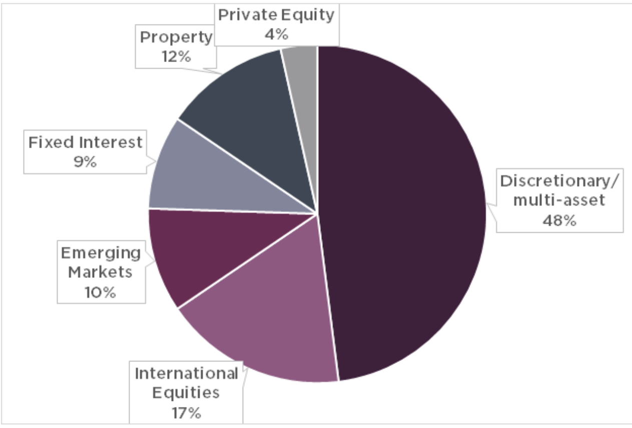
The asset allocation that is prescribed in the investment guidelines for the total portfolio is as follows:

Fund	Minimum	Maximum
International equities	0%	70%
International Bonds	0%	50%
Short Term Assets < 1 year	0%	30%
Property	0%	20%
Private Equity	0%	20%

The International Bond maximum was reduced from 70% to 50% in July 2015. A Sterling currency guideline minimum of 50% was introduced at the same time.

Investment guidelines are provided to each manager based on a risk budgeting approach.

The broad strategic asset allocation of the Long-term Reserve is as follows:



* Based on information as at 31/10/2015.

There is no explicit rebalancing of the portfolio to any central benchmark allocation.

Discretionary/multi-asset managers have the ability to change the asset allocation within a broad range. The wide asset allocation range could be a possible cause for concern where a strong position taken by an active manager proves to be wrong or where significant transaction costs are incurred.

However, there is little evidence that this has taken place and in practice the total portfolio allocation between the main asset classes has remained fairly stable over the last three years for which information is available. Taking into account the assets held in discretionary/ multi-asset mandates, approximately half of the total portfolio has been invested in equities and 28% in fixed interest /cash, with the balance held in alternative assets.

A survey of the world's largest pension funds (OECD 2014 Annual Survey of Large Pension Funds and Public Pension Reserve Funds) indicated that the average pension scheme had 31.5% of assets invested in equities, with the United Kingdom having the largest allocations to listed equities.

The Pensions and Lifetime Savings Association (PLSA) reported in July 2013 (Trends in defined Benefit Asset Allocation) that UK pension schemes' allocation to equities has fallen from 50% in 2008 to 38% in 2013. The allocation to equities in the UK Local Government Pension Scheme has been more gradual falling from 65% to 55% over the period 2000 to 2010.

The Long-term Investment Reserve's allocation to Private Equity is expected to grow over time. Although the short term target allocation is 3.5% it has been agreed that the allocation will grow to a maximum allocation to this asset class of 10% and a total of 20% to 'alternatives' (private equity and property). The PLSA survey indicated that the total allocation to alternatives (hedge funds, property, private equity, and infrastructure) amongst private occupational pension schemes in the UK has grown from 17% in 2008 to 26% in 2013. However an allocation of 10% would be at the higher end of the range of allocation of UK local authority pension schemes surveyed by the PLSA Local Government Pension Scheme Survey 2013.

The Investment Rules have been amended to allow up to 10% of the assets in investments where the majority of revenues are derived from Guernsey. This is in contrast to the main States of Jersey Social Security funds and the Jersey Public Employees' Contributory Retirement Scheme which specifically prohibits local investment to ensure that assets are diversified away from the effects of the local economy.

We do not have any concerns regarding this change, assuming such investments are to be based on their investment merits and that conflicts of interest are managed or avoided.

The overall asset allocation is reasonable given the investment return target.

2.3.2 Medium-term Investment Reserve

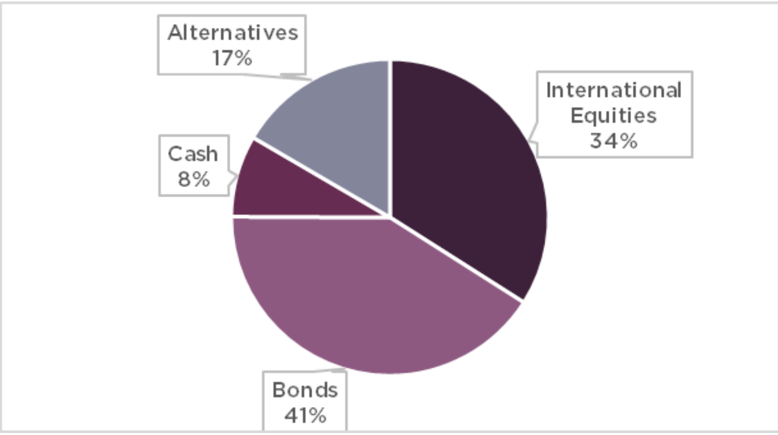
The Medium Term Investment Reserve was formed on 30 June 2015. This fund initially comprised the 'Contingency Reserve Fund' until the formation of the States' 'General Investment Pool' on 31 December 2011. The General Revenue / Cash Pool were combined with the General Investment Pool as at 31 December 2014. The asset allocation that is prescribed in the investment guidelines for the Medium-term Reserve is as follows:

Fund	Minimum	Maximum
International equities	0%	50%
International Bonds	0%	80%
Short Term Assets < 1 year	0%	50%*
Alternative Investments	0%	20%
Private Equity	0%	20%

* Temporary increase (from 31 December 2014) to accommodate the receipt of the States of Guernsey Bond issue proceeds.

The broad strategic asset allocation of the Medium Term Reserve is 50% in bonds/cash and 50% in growth assets (equities and alternatives).

The broad asset allocation of the Medium Term Reserve at 31/10/2015 was estimated as follows:



In practice, the entire assets are allocated to three multi-managers with each having distinct investment guidelines.

The current asset allocation has been distorted due to the temporary increase (with effect from 31/12/2014) in the maximum exposure to be held in cash given the receipt of the States of Guernsey Bond issue proceeds.

The asset allocation between managers excluding cash held with RLAM Guernsey is broadly expected to meet the return target for the Medium-term investment reserve given each manager's investment objective. The investment return objectives for the managers are as follows:

Fund	Objective	Allocation	Return Contribution
Fund Manager 1	RPI plus 3.5% p.a.	37%	1.28%
Fund Manger 2	RPI plus 4.0% p.a.	35%	1.38%
Fund Manager 3	RPI plus 2.5% p.a.	28%	0.70%
		100%	3.37%

2.4 Manager Structure and Selection

2.4.1 Manager Structure

The manager structure and selection is agreed by the T&R Department Board based on the recommendations of the ISC. The ISC itself will make recommendations to the Board regarding the manager structure and selection based on recommendations put forward by the Investment Working Group.

In practice the T&R Department Board is heavily reliant on the Investment Consultant when making decisions on manager structure and selection. This is particularly important as the manager structure reflects a significant allocation to active managers where the managers' skill at making the appropriate asset allocation and stock selection decisions are the primary drivers of investment returns.

Evidence suggests that the Investment Consultant has undertaken few significant changes to the selection / appointment of the managers of both the Long-term Investment Reserve and the Medium-term Investment Reserve. In practice however, the asset allocations between managers and the investment guidelines with each manager have changed over time to reflect the views of the Investment Consultant and the ISC.

The Long-term Investment Reserve maintains a core holding of roughly half of the assets, which are allocated to various managers in each asset class, namely:

- Global Equity
- Fundamental equity
- Emerging Market equity/debt
- Fixed Interest
- Hedge Fund of Funds
- International Property
- Private Equity
- Cash and equivalent

Only the allocation to fundamental equity (representing 10% of the portfolio) is managed on a passive basis.

The remaining assets are placed with discretionary/multi-asset managers who are able to change the asset allocation within the guidelines set by the ISC. In addition, there is a dynamic passive currency overlay.

There are 17 managers in total which, in our experience, appears to be more than usual. Whilst it is noted that the States' assets are not a single pension scheme, a December 2015 survey of pension scheme trustees published by Hymans Robertson found that 48% of pension schemes had 3-5 managers and fewer than 4% had 15 or more managers.

The large number of managers leads to two issues:

- Fee levels may not be at their lowest (i.e. a higher allocation to fewer managers should attract lower fees)
- Governance time / cost will be increased.

We have discussed the first issue with IAM Advisory, who have advised that they manage fees through negotiation with each manager and they believe that there would be little scope for further fee reductions based on higher asset allocations. We have been informed that a full fee review was commissioned by the ISC in November 2015 and that the ISC has agreed that a formal, annual review will be scheduled in future.

Evidence provided by surveys published by LCP (LCP Management Fees Survey 2013) suggests that significant savings can be made through consolidating mandates, undertaking benchmarking exercises and requesting managers to consider the combined States' assets (i.e. considering managers used by the Social Security Department).

In addition, management fees have risen automatically in line with asset values, which have themselves risen substantially more than inflation.

The LCP Investment Management Fees Survey 2015 argues that the existing fee basis for many mandates poorly align the interests of investor and investee, often resulting in the investment manager being rewarded simply for keeping a client rather than delivering a good return. Performance related fees can help improve the alignment of interests, particularly if there is a relatively low fixed fee element and the value added by the manager, rather than the market, is rewarded through a performance bonus.

More generally, it is not clear whether details of transaction costs information is provided and challenged.

> **We recommend that the impact of transaction and other fees is included in the formal review of fees, and that the T&R Department considers managers used by the SSD when considering any changes to managers (and vice versa).**

An obvious example where a single manager could be used is in the area of passive global equity, where the T&R Department assets are managed by State Street and the SSD CIF assets are managed by BlackRock.

Whilst it is acknowledged that there will inevitably be higher governance requirements around having a higher number of managers, the current governance structure that is in place is sufficient to cope with these requirements. In addition, the Investment Consultant currently believes that having a larger number of managers is key to the success of the investment strategy.

We do not have any concerns with the manager structure.

2.4.2 Manager Selection

We have been provided with examples of the following documents relating to manager selection:

- Investment Manager Selection Report
- Investment Recommendation
- Report entitled – Private Equity – an investment option for the Superannuation Fund dated 17 May 2013.

We have also discussed with IAM Advisory their process for screening suitable managers/funds from the universe available and we are comfortable with the mix of objective and subjective criteria used to screen investment managers. We have not specifically reviewed the due diligence process relating to the existing managers.

A decision has been made to appoint a number of Guernsey based discretionary managers for the Medium-term Investment Reserve. The selection process is likely to result in particular scrutiny due to the potential for conflicts of interest in an island economy. All parties involved are fully aware of this and have ensured that the process is above reproach.

> **We recommend that, for the purposes of demonstrating the good governance in place, any existing or potential conflicts of interest are disclosed at the beginning of each meeting of the Investment Working Group and Investment Sub-Committee and recorded in the minutes.**

2.5 Performance Monitoring

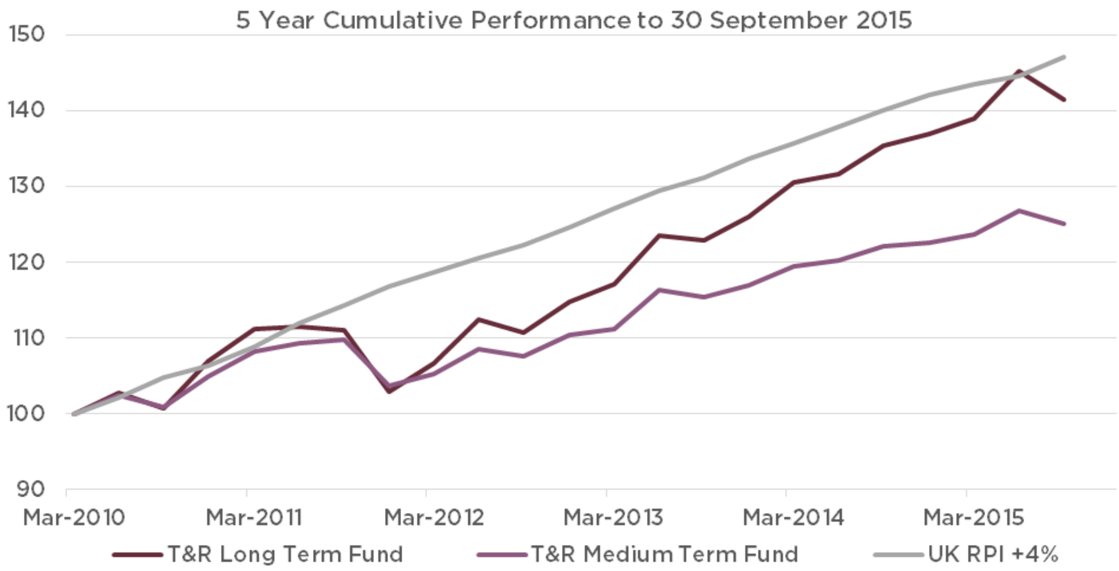
The Investment Consultant provides comprehensive reporting on a monthly basis to the Investment Working Group and the ISC.

Managers are measured against the range of potential investment returns derived from a series of indices representing the investible universe or ‘opportunity set’. Depending on the mandate managers will have an alternative, longer term target (e.g. an absolute return above inflation).

This approach is unusual compared to a formal benchmark but does avoid closet ‘index tracking’ by the manager and encourages greater tactical asset allocation. The use of an ‘opportunity set’ allows the Investment Sub-Committee to consider a manager’s ability to outperform the absolute and relative return objectives in different market conditions.

We have obtained details of the monthly total portfolio returns from the Investment Consultant and investment returns over the last 5 years and the overall investment risk calculations appear correct. We have been advised by IAM Advisory that all managers' performance reporting is based on Global Information Performance Standards 'GIPS'. We have not attempted to confirm this independently with all managers.

We have examined the returns and volatility of the Long Term Investment Reserve and the Medium Term Investment Reserve over the last five years, together with the investment objective of UK RPI plus 4% p.a.



As can be seen from the chart above, the Long-term Investment reserve has failed to meet its investment target of UK RPI plus 4% over last five years. However over the last three years the Long-term Investment Reserve has achieved a return of 7.1% p.a. compared to an objective (UK RPI plus 4%) of 5.9% p.a.

Fund managers have clear written mandates covering scheme expectations, which include clear time horizons for performance measurement and evaluation. We have not reviewed the performance of individual managers although we have noted that IAM Advisory have a robust process for managing performance on a monthly basis. IAM Advisory monitor managers against a median of the range of possible outcomes and expect the manger to be above average on a continuous rolling three month basis. This ensures that any under-performance is identified early and reviewed.

The Investment Working Group meets all managers on an annual basis.

Although the Medium-term Investment Reserve has an objective of UK-RPI plus 3.5%, the objectives for the fund and the underlying funds have changed considerably over the period of review. As a result, directly comparing the returns against this objective would not be appropriate.

Importantly, the amount of assets held in low yielding bonds and cash has been significantly higher in the past. In addition, declining yields on bonds over the last five years has had a positive impact on bond prices. The overall return and risk profile of the Medium-term Investment Reserve relative to the Long-term Investment Reserve appears entirely consistent with our expectations

2.6 Ongoing Governance

Although we do not have any significant concerns with the ongoing governance of the funds under the control of the Treasury & Resources Department, there are some areas where we believe improvements can be made.

We understand that the ISC obtains and reviews internal control reports (AAF 01/06) from each of their investment managers. We have not considered the appropriateness of any internal controls with the Treasury and Resources Department.

Earlier in this report we have highlighted that a register of conflicts of interest should be maintained and we have suggested that a more fundamental review of the Investment Sub-Committee should be undertaken to ensure greater continuity and that appropriate training is provided in a timely manner.

2.6.1 Investment Policy Statement / Governance Document

At present there is no single document that sets out the investment policy and governance framework for the Treasury and Resource Department. Instead, it is necessary to review a variety of documents and have some history of the investments in order to understand how the current policy operates. This is even more relevant given the substantial changes that have taken place recently and the ongoing changes to the investment structure (such as increased private equity funds/ managers, Guernsey Investments and Guernsey based fund managers). In addition, such a document would aid new members of the Investment Sub-Committee, which could change entirely following each election.

> **We recommend that the Investment sub-Committee considers preparing and maintaining a Governance Framework Document for the T&R Department on a similar basis to the document prepared by the Social Security Department.**

2.6.2 Investment Business Plan

The purpose of a Business Plan is to outline the strategic direction, goals and objectives, as well as providing an action plan of the key priorities over the next period of time in order to further these objectives.

> **We recommend that the Investment Sub-Committee follows best practice guidance and should have a forward looking investment business plan and evaluate progress against this on a regular basis.**

2.6.3 Resources

The work of the ISC is supported and updated by Bethan Haines (States Treasurer), Liz Stonebridge (Investments Manager) and Martin Sines (Senior Finance Manager – Investment Accounting). They liaise closely with IAM to implement any decisions of the ISC and monitor compliance with the permitted investment rules and performance. They are also responsible for maintaining the accounting records of the Investment Funds and liaising with another team within the Department to monitor cash flows, and overdraft requirements etc.

The Investment Sub-Committee should be responsible for ensuring that there are sufficient internal resources and access to external resources for the Investment Sub-Committee to make effective decisions.

We have not examined whether it would be more cost effective to make greater use of internal rather than external resources, particularly around regular reporting and monitoring of the asset managers. However this may be an area where marginal improvements and cost savings can be considered.

2.6.4 Responsible Ownership

At present there is no formal policy on responsible ownership. This is a challenging issue to consider as there are often competing forces at play regarding the extent to which the Department wishes to balance the desire to maximise investment returns with responsible investment, including environmental, social and governance issues. Nonetheless, the States of Jersey have a clearly set out a policy and the Social Security Department has documented their position.

We recommend that the Investment Sub-Committee:

- **Reviews and publishes their policies regarding responsible ownership.**
- **Considers the potential for investment managers to add value through actively engaging with the companies in which they invest when formulating investment strategy and selecting investment managers.**
- **Ensures that investment managers have an explicit strategy, setting out the circumstances in which the investment managers will intervene in a company.**
- **Takes into account their investment managers' statements on compliance with the UK Stewardship Code and whether they are signatories to the United Nations Principles for Responsible Investment (UNPRI) when evaluating and selecting managers.**

3. SOCIAL SECURITY DEPARTMENT

The Social Security Department has mandated responsibility to control and manage three funds:

- The Guernsey Insurance Fund – providing old age, sickness, unemployment and other benefits;
- The Guernsey Health Service Fund –providing prescription drugs, specialist medical care and GP consultation subsidies;
- The Long-term Care Insurance Fund – providing nursing and residential care assistance in old age.

We met with the following representatives on 17 December 2015:

- Allister Langlois – Minister
- Malcolm Nutley – Chief Officer
- Joe Brown – Finance Business Partner
- Michael Brown – Non-States Member

We also met with John Conroy and Mike Burdett of P-Solve on 11 December 2015.

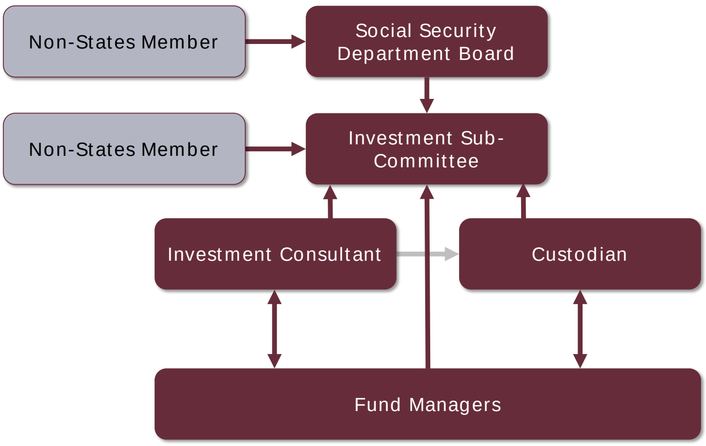
The Social Security Department has created a Common Investment Fund (CIF) which combines the assets of all three funds into one single investment fund. The Guernsey Insurance Fund makes up the largest reserves forming part of the CIF.

All three funds were created on a pay-as-you-go basis and are not intended to be pre-funded. As a result there is no intention to fully fund the benefits provided. Instead, the funds are intended to smooth out the volatility in contribution rates. However the investment performance of the funds will have a direct bearing on the pace at which contributions need to be adjusted over time.

The Social Security Department maintains a detailed Governance Framework Document for the Common Investment Fund, from which much of the information contained in this report has been obtained.

3.1 Current Structure

The SSD Board currently retains overall responsibility for the investments. The SSD Board is made up of five elected politicians and one non-States member approved by the States. Various investment activities are currently delegated as shown below:



3.1.1. Social Security Department Board

The SSD Board is made up as follows:

- Minister Allister Langlois*
- Deputy Sandra James MBE
- Deputy John Gollop
- Deputy Michelle Le Clerc*
- Deputy David Inglis*
- Michael Brown, Non-Voting Member*

** Investment Sub-Committee Members*

The SSD Department Board members serve a four year term and there is no guarantee of continuity beyond the end of each term. The next election is due to take place in April 2016.

3.1.2. Investment Sub-Committee

The SSD Department Board retains overall discretion as to whether to operate an investment sub-committee and will decide on which activities are delegated.

The Investment Sub-Committee membership* (ISC) comprises four Members. The Minister is always on the ISC. Other ISC members are selected based on their knowledge and experience of investments.

The current ISC holds a minimum of 4 meetings per year and reports to the SSD with any formal recommendations that require full departmental approval.

ISC Meetings are attended by the Investment Consultant, the Chief Officer, and the Finance Business Partner. Members of the Treasury and Resources Department Investment Sub-Committee are also invited to attend on a reciprocal basis.

The ISC also meets with each of the investment managers on an annual basis.

The appointment of Non-States Member Mike Brown adds to the experience of the Sub-Committee. Non-States member positions fall at each General Election, so continuity is not guaranteed. The new post-election Board may seek States approval for reappointment of previous Non-States members. We have not considered the level of remuneration for Non-States Members.

There is a lack of continuity amongst the members of the Investment Sub-Committee and there is no clear way in which this can be addressed without impacting on the broader political structure. There is also the risk that the ISC and SSD have the power to make investment decisions without the knowledge and experience required. The ISC should have sufficient expertise to be able to evaluate and challenge the advice they receive, and manage conflicts of interest.

Our recommendation in relation to the T&R Department applies equally to the SSD

3.1.4. Investment Consultant

The Investment Consultant advises on the strategic asset allocation, manager structure, manager selection and risk controls of the Common Investment Fund.

The Investment Consultant is responsible for advising on:

- Investment strategy including:
  - Overall target investment return
  - Strategic asset allocation
  - Risk and return characteristics
  - Cash flow and rebalancing

- Fund Managers
  -Selection and de-selection
- Occasional tactical movements in asset allocation to take advantage of market opportunities.
- Governance
- Responses to queries raised by the Department and its officers.

The Investment Consultant will provide training to Department members in specific areas as necessary.

We recommend that an investment training needs analysis be undertaken for all ISC members on a regular basis and that a training plan be developed based on this.

P-Solve Asset Solutions were appointed in 2009 for a three year period following a competitive tender process. This appointment was subsequently extended until 31 December 2015. We understand that Redington were appointed in place of P-Solve with effect from 1 January 2016 following a formal tender process.

The review of P-Solve confirms that the ISC is actively monitoring their advisers and are able to make changes as and when required.

3.1.5. Custody Services

Northern Trust currently provides custody services. Where pooled funds are used, the investment manager will appoint the custodian. The majority of the assets are now in pooled funds which have separately appointed custodians. In such cases Northern Trust assumes custody of the units in the fund on behalf of the Department.

The Custodian maintains the security of all the financial assets and is responsible for:

- Core Custody Services including:
  -Safe keeping of assets
  -Trade settlements
  -Income collection
  -Corporate action processing
  -Proxy voting
  -Tax reclamation
- Securities Lending
- Monthly Performance analytics and Quarterly Executive Reporting
- Monthly valuation reporting and sign-off reconciliations

Northern Trust assists in transition management, reducing costs through in-specie transfers, crossing buyers and sellers, and arranging the prefunding of cash transfers.

Northern Trust provides tax advice and reclaiming tax where appropriate. Northern Trust has recently assisted the SSD in recovering tax on a UK fund.

Northern Trust obtains asset values and calculates performance information. This is checked by P-Solve and discrepancies accounted for. We are aware that asset valuation and performance information has differed between P-Solve and Northern Trust. This is not uncommon and we do not believe that the discrepancies are material.

We understand that an independent review of the custodian has been carried out by Mercer and there were no serious concerns. The amount of stock lending has reduced dramatically since 2008/2009 and is now negligible.

We understand that consideration is being given to the appointment of Northern Trust Guernsey rather than London. We do not have any concerns regarding this change.

3.2 Current Objectives and Risk Appetite

The Social Security Department will seek the maximum return on its investments within agreed levels of risk and the Permitted Investment Rules of the States of Guernsey. In examining the current risk and return objectives, we have assumed that these are reflected net of all fees. We have also largely ignored the impact of active management.

3.2.1. Investment Return Objective

The Social Security Department Framework for the Common Investment Fund states that the investment objective is to achieve equity-like returns in a risk controlled manner.

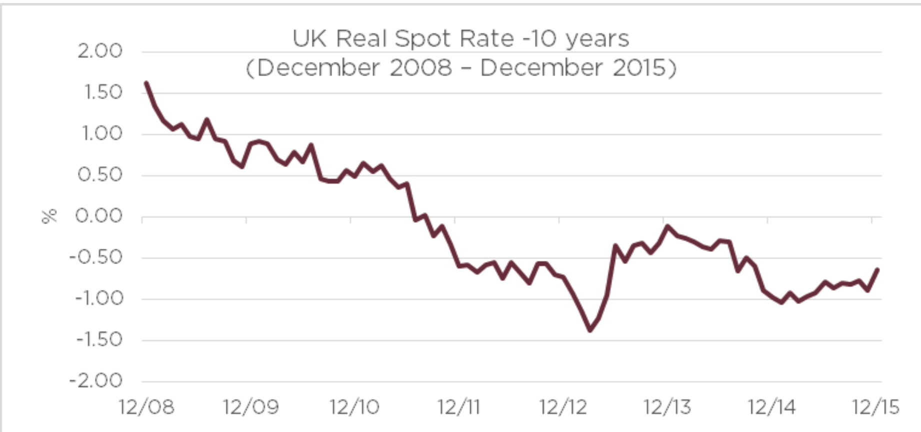
One of the key investment principles stated in this document is that investment decisions will consider the long term nature of the liabilities to be covered and the assumptions made by the Actuary in the actuarial reviews of the funds participating in the CIF. The funding strategy for all three funds invested in the Common Investment Fund was last reviewed on 31 December 2009. The next funding reviews as at 31 December 2014 were in progress at the time of this review. All three funds assumed an investment return of Guernsey RPIX plus 3.5% p.a.

Because it is not possible to invest in 'Guernsey RPIX', it was considered necessary to convert this funding objective into a suitable investment benchmark. Following advice received from the Investment Consultant, the Investment Sub-Committee accepted the following investment objectives:

- Three month LIBOR plus 2.5% p.a. and
- Guernsey RPIX plus 3.5% p.a.

We do not have any documentation explaining how three month LIBOR plus 2.5% p.a. equates to Guernsey RPIX 3.5% p.a. However this may have appeared appropriate at the time it was implemented in 2009 as LIBOR was expected to generate a return above inflation over the long term as investors should, in theory, demand a real return above inflation. At the time the strategy was implemented, real yields were above 1% p.a.

In practice, the effect of the financial crisis and the Bank of England's 'Quantitative Easing' programme has resulted in a sustained period of negative real yields. Over the five years to 30 September 2015, real yields have fallen considerably.



In discussions with the Investment Consultant it was recognised that this performance objective may no longer be appropriate with the passage of time. Over the last five years LIBOR plus 2.5% p.a. would have resulted in a lower return than Guernsey RPIX plus 3.5% p.a. LIBOR has returned 0.7% p.a. over the last five years compared with Guernsey RPIX of 2.1% p.a.

An analysis of each manager's objectives indicates that the long term risk premium for equities has been quoted as three month LIBOR plus 4% p.a. - slightly higher than the objective for the overall CIF. The implicit return target for the CIF of three month LIBOR plus 2.5% p.a. is therefore slightly lower than equities (perhaps reflecting at least some allocation by managers to defensive / alternative assets such as bonds). This is at odds with the stated investment objective of equity like returns.

We have also noted that the blended objective for all of the managers is 3m LIBOR plus 4.4% p.a. Although this may provide a better comparison with the fund objective of Guernsey RPIX plus 3.5% p.a. this difference should be clarified by the Investment Sub-Committee.

We have compared the current asset allocation to the expected Sterling returns published by JP Morgan (2016 Capital Market Return Assumptions) and derived a nominal long term expected return for the Common Investment Fund of approximately 5.3% p.a.

JP Morgan's Capital Market Assumptions also assumes a long term rate of inflation for the UK of 2.25%, resulting in a return above inflation of 3.1% p.a.

Asset Class	JP Morgan Capital Market Assumptions 2016	Long Term Compounded Return (p.a.)	Illustrative Asset Allocation
Multi-Asset	AC World less 0.5% p.a.*	5.5%	25.0%
International Equity	AC World Equity	6.0%	33.0%
Broad Bonds	45% World Government Bonds/ 45% US Investment Grade Hedged/ 10% High Yield	3.4%	22.0%
Alternatives	Various**	6.0%	3.5%
Total Long Term Expected Return		5.3%	100%
Total Long Term Expected Return above UK inflation		3.1%	100%

*We have made a very broad assumption that the Multi-Asset managers earn 0.5% below equities. If it is assumed that the multi-asset managers earn equity returns, the increase in the expected return of the total portfolio is an additional 0.1% over the long term.

**Private Equity, Real Estate, Hedge Funds, High Yield Bonds, Infrastructure

As we have pointed out under Section 2 of this report, there are various arguments that could be put forward as to why the current investment return objective is appropriate.

We recommend that the investment objectives for the Common Investment Fund be reviewed and clarified.

3.2.2. Investment Risk Objective

The current objective is to target a level of volatility of between half and two thirds of the level of volatility of equities. When P-Solve were appointed the CIF was heavily invested in equities, and had experienced significant volatility during the financial crisis of 2008/2009. As a result, the emphasis of the investment strategy changed with greater emphasis placed on delivering the assumed return required for funding but with lower investment risk within the portfolio. We believe that this is an appropriate risk objective and that the nature of the portfolio and the mandates given to the managers supports this.

The Governance Framework Document for the Common Investment Fund provides further detail relating to other sources of risk and their management.

3.3 Asset Allocation

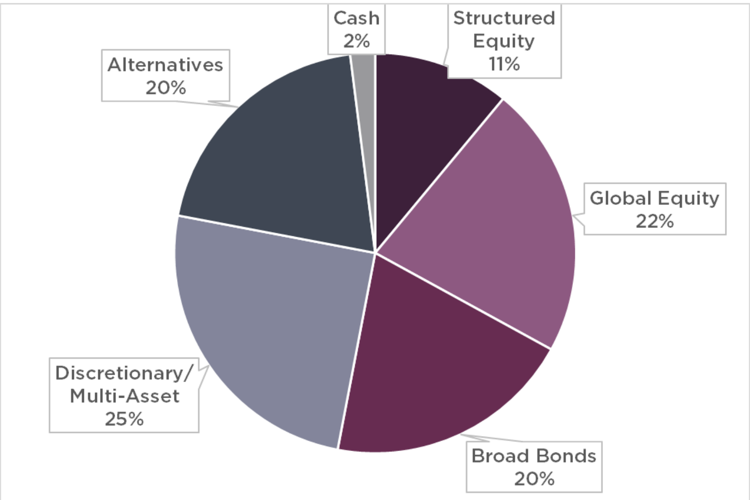
The authorised investments are set out in the Resolution of the States No X111 on Billet d'Etat XV of 2011 and which, at that time, were the same as the T&R Department Permitted Investment Rules. We understand that, unlike the T&R rules, no subsequent change has been made to the SSD asset allocation rules to allow explicitly for up to 10% of assets to be held in investments focused on corporate entities where the majority of their revenue is derived from undertakings in Guernsey.

The SSD ISC approves investment guidelines at both the total portfolio (CIF) level and manager level. The Investment Consultant assists in preparing detailed investment guidelines, monitoring the investment managers and resolving day-to-day issues.

The asset allocation for the CIF has been based on advice received from the Investment Consultant. The CIF invests through each of its underlying managers to make use of the following investment principles:

- Diversification across and within asset classes;
- Rotation between stocks and asset classes to achieve a higher rate of return over the economic cycle;
- Hedging risks that are unrewarded or undesirable to adjust the risk profile of the portfolio;
- The use of active management where there is the potential to add value.

The strategic asset allocation of the CIF at 30 September 2015 was as follows:



There is a range of investment objectives (and risk allocations) for each manager, with some being higher than others.

Asset Class	Strategic Allocation %	Investment Objective p.a.	Investment Objective (Cash + x p.a.)
Structured Equity	11	Cash +10%	3m LIBOR +10%
Global Equity	11 11	15-20% MSCI World	3m LIBOR +4% 3m LIBOR +4%
Broad Bonds	20	3m LIBOR +3%	3m LIBOR +3%
Dynamic Asset Allocation	15 10	3m LIBOR +3% G7 CPI +5%	3m LIBOR +3% 3m LIBOR +5%
Alternatives	20	3m LIBOR +5%	3m LIBOR +5%
Cash	2	7 Day LIBID	3m LIBOR +3%

The structured equity mandate gives downside protection to 35% falls in equity markets for 95% of the capital invested. The upside return is geared to 197% to generate strong returns in rising markets to a target return of cash plus 10% p.a.

Discretionary/multi-asset managers have the ability to change the asset allocation within a broad range.

The allocation to alternatives is limited to a single manager with a wide brief in asset allocation. The manager is informed on a quarterly basis of the asset allocation of the remainder of the portfolio and is expected to invest in other sources of return such as private equity, hedge funds, high yield bonds, commodities and property.

There is no explicit rebalancing of the portfolio to the strategic benchmark allocation although this is monitored on a quarterly basis.

The Guernsey Insurance Fund, which makes up the bulk of the assets in the CIF, operates on a pay-as-you-go basis. Based upon the 2011 Actuarial Review, operating deficits will progressively increase, reducing the approximate 5 years' annual expenditure cover of the Guernsey Insurance Fund down to a 2 years' cover by around 2040.

In view of this, it is recognised that cash flow management, including increased use of short-term fixed income, will feature increasingly in the management and governance of the Common Investment Fund.

We therefore consider that the 20% allocation to fixed income, and an expected lower investment return for the CIF as a result, is appropriate. More broadly, the asset allocation and share classes (e.g. moving from accumulation to income units) may need to be reviewed to reflect the increasing drawdown of assets.

The Investment Consultant and the Investment Sub-Committee are aware of this.

The investment strategy is reviewed by the Investment Consultant and the Investment Sub-Committee on an annual basis. A more detailed look at the assets and liabilities is conducted on completion of each actuarial review.

3.4 Manager Structure and Selection

3.4.1 Manager Structure

The Manager Structure and Selection is agreed by the SSD Department Board based on the recommendations of the ISC. The ISC itself will make recommendations to the Board regarding the manager structure and selection based on recommendations put forward by the Investment Consultant.

The SSD Department Board is heavily reliant on the investment Consultant when making decisions on manager structure and selection. This is particularly important as the manager structure reflects a significant allocation to active managers where the managers' skill at making the appropriate asset allocation and stock selection decisions are the primary drivers of investment returns.

The CIF maintains a core holding of 53% of the assets, which are allocated to various managers in each asset class, namely:

- Global Equity
- Structured equity
- Broad Bonds
- Alternatives.

Only 11% of the total assets invested in the global equity mandate are managed on a passive basis, following the decision to disinvest from an active equity manager. All other mandates are managed on an active basis.

The remaining assets are placed with discretionary/multi-asset managers who are able to change the asset allocation within the guidelines set by the ISC.

There are six managers and eight funds/mandates in total which, in our experience, appears to be reasonable.

The Investment Consultant is of the view that there is little scope to extract further fee reductions from the existing managers. We have reviewed the annual management fees detailed in the Governance Framework document and, based on our experience, these seem reasonable.

We recommend that a periodic review of fees be undertaken to ensure that management fees and transaction costs remain appropriate and competitive, and that the SSD considers managers used by the T&R Department when considering any changes to managers (and vice versa).

3.4.2 Manager Selection

We have also discussed with P-Solve Asset Management their process for screening suitable managers/funds from the universe available and we are comfortable with the mix of objective and subjective criteria used to screen investment managers. We have not specifically reviewed the due diligence process relating to the existing managers. Detailed manager due diligence information prepared by the Investment Consultant has not generally been shared with the Investment Sub-Committee. The Investment Sub-Committee has therefore relied on Investment Consultant.

Evidence suggests that the SSSD Board, on advice from the Investment Consultant has undertaken some changes to the manager selection of the CIF. Recent examples include:

- Replacing the structured equity mandate with a new structure in Q1 2014;
- Replacing a discretionary/ multi-asset manager with two alternative managers ;
- Disinvestment from a European loan fund and an active equity manager;
- Investments in the ‘Completion’ (alternatives) portfolio Q1 2013;
- Disinvestment from index-linked gilts manager 2014;
- Review of the asset allocation to global equity manager.

We recommend that, for the purposes of demonstrating the good governance in place, any existing or potential conflicts of interest are disclosed at the beginning of each meeting of the Investment Sub-Committee and recorded in the minutes.

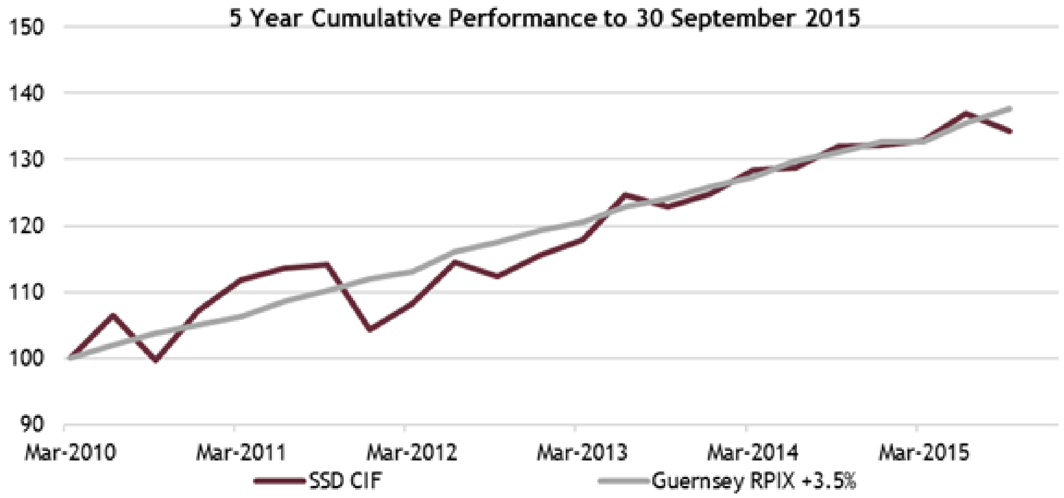
3.5 Performance Monitoring

The Investment Consultant provides comprehensive reporting on a quarterly basis to the ISC.

The overall investment performance of the CIF is measured against the investment return objectives. We have been provided with a copy of P-Solve’s Investment Governance Reports. The latest report provided for Quarter 3 2015 indicated that the CIF’s cumulative investment performance since September 2009 had exceeded the investment objective of 3 month LIBOR plus 2.5% p.a. and had exceeded the second objective of Guernsey RPIX plus 3.5% p.a. since inception to June 2015, falling behind this benchmark by 0.4% p.a. at the end of September 2015. The CIF has also met its risk objective since inception, with volatility of 7.9% p.a. compared to a target (2/3rds of equities) of 9.0% p.a.

We have obtained details of the quarterly total portfolio returns reported by the Investment Consultant over the last 5 years and the overall investment return and risk calculations appear correct.

We have examined the quarterly return of the SSD over the last five years and this is reflected in the chart below, together with the overall objective of matching Guernsey RPIX plus 3.5%.



As can be seen from the chart above, the CIF has failed to meet its investment target of Guernsey RPIX plus 3.5% over the last 5 years due to poorer short term performance. However the CIF performance is broadly in line with its objective.

Performance of the CIF is also measured relative to a 'Passive Opportunity Set' made up of

- 70% global equities
- 10% corporate bonds
- 5% emerging market debt
- 5% high yield fixed income
- 5% UK Property and
- 5% commodities.

We understand that this is broadly representative of the asset allocation prior to 2009. The decision to diversify and reduce risk within the strategy in 2009 has led to lower returns (and lower risk) relative to equities which have had a strong bull run over the period 2009 to 2014. As a result, the 'Passive Opportunity Set' has returned 7.5% p.a. over the last three years to 30 September 2015 compared to the CIF return of 3.9%.

From our discussions within SSD the recent performance of the CIF relative to the Passive Opportunity Set has inevitably led to some regret, although the recent correction in equity markets in late 2015/2016 is likely to have improved the relative performance of the CIF.

However, we believe that the decision to diversify the assets away from equities, and to allow an element of manager discretion in the allocation of assets between asset classes has been correct, despite the lower returns. We also support the Investment Sub-Committee's decision to focus on achieving the funding objective for all three funds at a lower level of risk.

We also do not support the use of peer group comparisons/ benchmarks as each fund and manager will have their own objectives and risk tolerances.

Some fund managers have clear written mandates covering the CIF's expectations. Other investments are held in collective investment schemes and therefore the Investment Sub-Committee effectively accepts the investment objective set by the manager of those schemes. In order to provide a standard basis for comparison across discretionary / multi-managers, P-Solve had created a common passive index benchmark, referred to as the 'Dynamic Asset Allocation Opportunity Set' (DAA Opportunity Set).

As a result, the quarterly governance report monitors managers against their own benchmark and, in the case of multi-asset / discretionary mandates, the DAA Opportunity set. However there is no comparison of each manager's performance against the investment objective used to derive the asset allocation between managers (a '3-month LIBOR Plus' objective). It is therefore not immediately clear from the quarterly monitoring report how each manager is contributing to their fund specific LIBOR plus target or the overall CIF return objective.

Meetings with the Investment manager are conducted annually.

Although of academic interest since the appointment of Redington in place of P-solve in January 2016, we have discussed the process for reviewing investment managers with P-Solve and believe that they have a robust process for identifying and reviewing underperformance. We have not reviewed the performance of individual managers although clearly some managers will have underperformed in the short term. In some cases market sentiment rather than fundamentals over the last 12-18 months have adversely impacted on manager performance and there has been an expectation that this will feed through to stronger returns over time. In other cases, P-Solve have recommended changes in the underlying manager.

3.6 Ongoing Governance

We do not have any particular concerns with the ongoing governance of the funds under the control of the SSD. The existing governance arrangements are clearly documented in the Governance Framework Document for the Common Investment Fund. The SSD also maintains a reporting framework and prepares a business plan which includes the major aspects relating to investments.

The Governance Framework Document for the Common Investment Fund also sets out the SSD's position on social and ethical investment, although the SSD's position is largely passive.

We recommend that the SSD's position on responsible ownership be made public.

Earlier in this report we have highlighted that a register of conflicts of interest should be maintained, that a more fundamental review of the Investment Sub-Committee should be undertaken to ensure greater continuity, and that appropriate training is provided in a timely manner.

3.8.2 Resources

The work of the ISC is supported and updated by the Chief Officer and the Finance Business Partner. They liaise closely with the Investment Consultant to implement any decisions of the SSD Board and monitor compliance with the permitted investment rules and performance. They are also responsible for maintaining the accounting records of the funds etc.

The Investment Sub-Committee should be responsible for ensuring that there are sufficient internal resources and access to external resources for the Investment Sub-Committee to make effective decisions.

Following discussions with the SSD we believe that there may be an overall shortage of accounting experience within the department. This could have operational and financial implications for the CIF.

We recommend that the internal resources available to manage the investments of the SSD should be reviewed. We also recommend that consideration be given to cross departmental support from the Treasury and Resources Department.

4. COMMON ISSUES

4.1 Combined Investments

The decision whether to combine the assets under the control of the SSD and T&R Department is a complex one that needs to take into account legal and political issues as well as the merits from an investment point of view.

However from a purely investment perspective, it would appear that the investment objectives of the assets of both the Treasury & Resources and Social Security Departments are broadly similar, and that cost savings could be achieved by amalgamating and rationalising the investments. This should result in a better allocation of resources internally and lower fees through fewer investment managers, a single investment consultant and larger asset allocations to each fund.

Whilst research done by LCP suggests that there is the potential to reduce investment management charges for schemes of this size, both existing Investment Consultants are sceptical that material reductions in fees can be achieved. Our own experience suggests that the views of the investment consultants are correct.

The potential to save on internal States of Guernsey resources is perhaps an area where we believe savings could be made, by providing shared internal resources for both Investment Sub-Committees.

A separate review has recently considered whether there should be a single investment consultant which has recommended that separate investment consultants should be retained. We support this recommendation, as we believe that alternative investment views and styles diversifies risk, and that this more than compensates for the additional costs incurred.

We are aware of the differing approaches to investment strategy and risk adopted by Redington (SSD) and IAM Advisory (T&R Department) and we believe that their different approaches will add value to the overall States Investments despite the additional cost. It should be borne in mind that the consulting charges represent a small proportion of the value of the assets, and yet the heavy reliance on the investment consultants will mean that they will have a large influence on the ultimate asset allocation and investment returns achieved. As you would expect to diversify active manager risk through having more than a single manager, diversifying overall risk through separate advisers between the departments should be seen in a positive light.

It should be noted that the States of Jersey use more than one investment consultant.

> **Given that the two investment consultants are independent of one another, consideration may be given to them each reviewing the others' recommendation on significant changes to strategy before any final decisions are implemented. This would add an additional layer of oversight.**

4.2 Peer Group Benchmarking

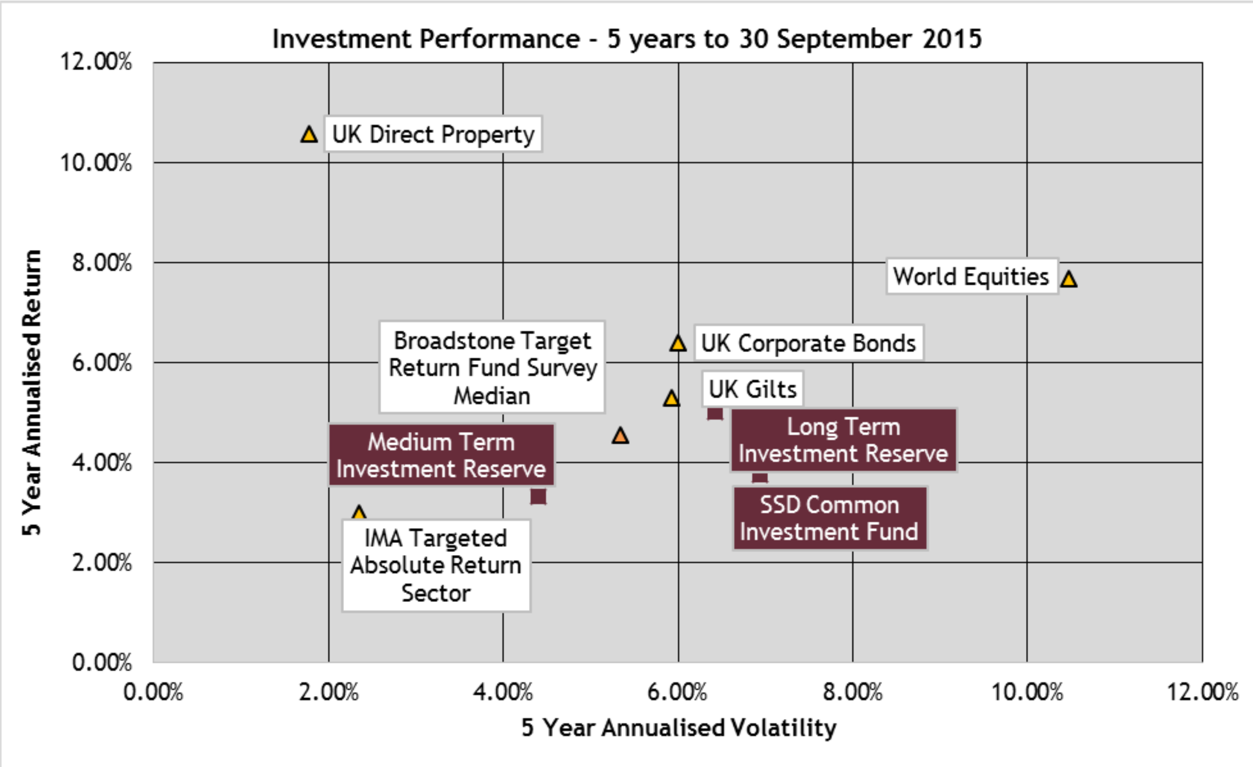
We are aware that some discussions have taken place regarding the relative performance of the funds and we have examined the performance relative to other funds/ managers

In order to consider the performance relative to other funds/ managers, we have taken the mean return from a sample of 19 target return funds that operate on a broadly similar basis to the discretionary/ multi-asset managers i.e. targeting inflation or LIBOR plus 3-5% used in the Long-Term Investment Reserve, Medium-term Investment Reserve and the Common Investment Fund. We have referred to this as the Broadstone Target Return Survey.

We have also included the overall risk and return information for the IMA Targeted Absolute Return Sector, which includes funds managed with the aim of delivering positive returns in any market conditions, although these returns are not guaranteed. Finally, we have included the risk and return data for equities and bonds to provide a frame of reference.

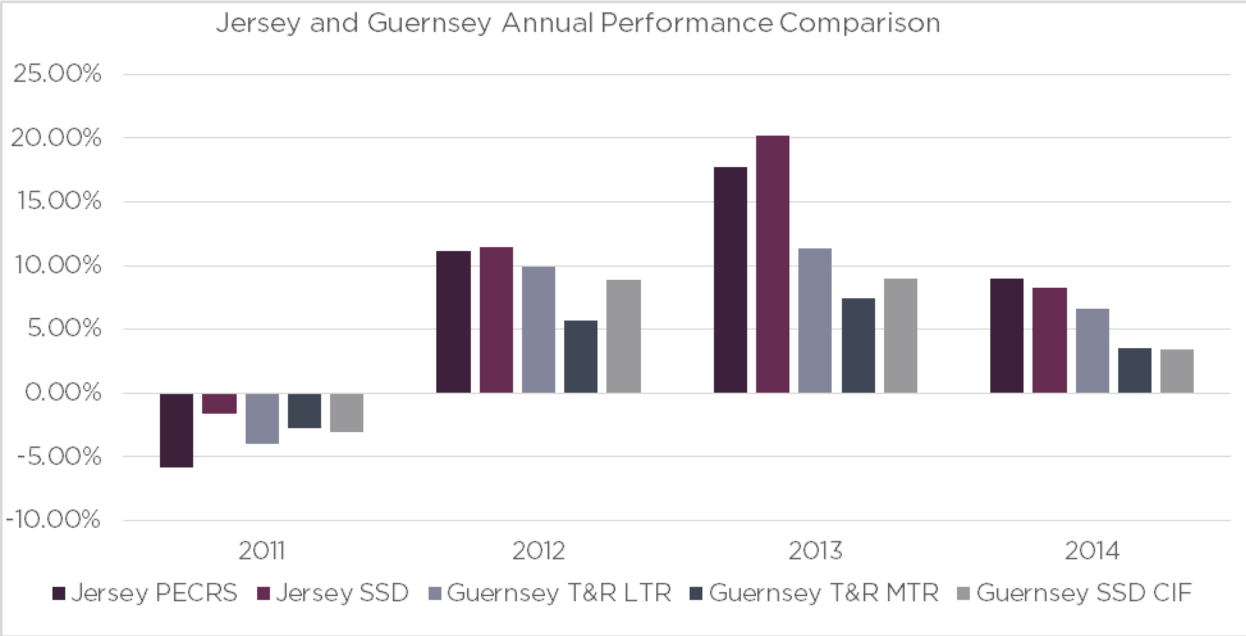
The returns of the T&R Department Long-term Investment Reserve fare well relative to these 'peer group' comparisons. Both the SSD Common Investment Fund and the Medium-term Investment Reserve have outperformed the IMA Targeted Absolute Return Sector but with increased risk.

The Broadstone Target Return Fund Survey median is higher than both the Medium-term Investment Reserve and the SSD Common Investment Fund. The Common Investment Fund has exhibited higher levels of risk relative to both the IMA Targeted Absolute Return Sector and the Broadstone Target Return Fund Survey median.



* Based on quarterly return data

We have also compared the performance of the States of Guernsey funds with the principle Jersey based investment funds, which are shown below:



The States of Jersey funds have a higher weighting to equities which has been a key driver of relative out-performance.

We have not had access to the volatility figures for the States of Jersey Funds. Given the higher allocation to equities, we would expect that the Jersey Funds are operating with a higher level of risk than the Guernsey Funds.

It is interesting to note that the States of Jersey have introduced greater diversification of investment pools over time. This increased diversification is similar to the approach taken within the States of Guernsey Funds.

We believe that the performance of the investment funds should not be simply measured against that of other investment funds, as each fund has its own characteristics. In his report on institutional investing fifteen years ago, Lord Myners highlighted the problem of peer-group benchmarking, which was common practice.

“The peer group benchmark tends to produce investment decisions – in particular asset allocation – based on what other [pension] funds are doing,” wrote Myners. “A pension fund should set its asset allocation because it believes, on the evidence available, that a particular allocation will best enable it to meet its liabilities at its projected rate of contribution.”

We therefore do not believe it appropriate to draw any particular conclusions from the above information and do not advocate peer group benchmarks solely as a means of measuring the performance of investment managers, consultants or States’ Funds.

5. SUMMARY AND CONCLUSIONS

We believe that the investment strategies adopted to invest the assets of the States of Guernsey are not unreasonable and that the overall risk and return characteristics are appropriate given the objectives of the various funds.

There is a lack of continuity amongst members of both Investment Sub-Committees (ISCs). We do recommend that the ISCs become permanent bodies and that a greater number ISC members are drawn from the States' executive and external sources, and that training is provided to all new ISC members. This is to ensure that they understand their roles and responsibilities and that they have sufficient expertise to evaluate and challenge the advice they receive, and manage conflicts of interest.

The SSD have comprehensive governance documentation in place relating to their investments. Given the significant changes to the T&R Department Funds in 2015, we recommend that formal governance documents are now put in place for the T&R Department.

Given that the SSD funds are effectively an insurance buffer, it is expected that they should be invested in a more risk controlled manner with the focus on capital protection. The risk and return profiles of the T&R Department and SSD department funds should therefore be expected to differ.

We believe that long term return expectations have generally fallen over time and that the investment return objectives for each of the investment funds may be optimistic. This may lead to higher risk strategies in order to maintain returns. All funds have failed to meet their investment return objectives over the last five years although performance has broadly been in line with the return target over time.

Funds under the control of the Treasury and Resources Department have generally performed better than the Social Security Department Common Investment Fund, and have shown lower levels of volatility. However, direct comparison may not be appropriate given the different approaches adopted by each. In broad terms, the Treasury & Resources Department Long-term Investment Reserve attempts to maximise returns for a given level of risk, whereas the focus of the Common Investment Fund has been to target the required return objective for the least amount of risk.

We do not believe that peer group comparisons are appropriate, although it is recognised that performance has lagged against other funds with a higher weighting to equities.

There have been no serious issues with the allocation of assets within each of the funds or the ongoing monitoring and governance arrangements. We have, however, indicated a number of areas where the governance and reporting may be improved.

6. IMPORTANT NOTES

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