REPORT TO: SUPERANNUATION INVESTMENT SUB-COMMITEE OF THE FINANCE COMMITTEE - 23 FEBRUARY 2005

REPORT ON: INVESTMENT IN TOBACCO

REPORT BY: DEPUTE CHIEF EXECUTIVE (FINANCE)

REPORT NO: 75-2005

1 PURPOSE OF REPORT

This report reviews the position regarding the investment in tobacco following this issue being raised at the Sub-Committee on 17 November 2004.

2 RECOMMENDATION

The Sub-Committee is asked to note the position regarding the Funds current exposure to tobacco products and the advice from the investment consultants, Hymans Robertson.

3 FINANCIAL IMPLICATIONS

None

4 LOCAL AGENDA 21 IMPLICATIONS

None

5 EQUAL OPPORTUNITIES IMPLICATIONS

None

6 BACKGROUND

At the last Sub-Committee it was agreed to review the Fund's position towards investment in tobacco companies. In particular, this was to look at the current levels of investment in such stocks and the likely impact of withdrawing from these investments.

7 INTRODUCTION

All the Fund Managers (excluding Schroder Property) were asked to provide a note of their current position and the effect of any change in policy. In addition, Hymans Robertson were asked for their views.

8 FIDELITY

Fidelity hold about £3.8m of stock directly which is slightly more than 1% of their holdings. Over three years to September 2004 they note that being invested in the broad market rather than the index share in tobacco would have lost a £150m equity portfolio £1.84m.

Whilst they could operate without investing directly in tobacco stocks by adjusting the benchmark, they would prefer to have maximum investment options. Where Fidelity invest through pooled vehicles, eg USA, it is not possible for any stocks to be screened out as there are many other investors involved.

9 BAILLIE GIFFORD

Baillie Gifford have approximately £11m invested in tobacco stocks. This represents almost 4% of their holdings and is therefore a significant overweight position.

They would be able to sell out of all direct holdings but it would make it more difficult to achieve performance targets.

10 ALLIANCE BERNSTEIN

Alliance Bernstein hold approximately £6.7m of tobacco stocks representing just under 2.5% of their portfolio. This has added to their out-performance.

They continue to monitor effects on stock values and engage regularly with management on ethical issues.

11 GOLDMAN SACHS

Goldman Sachs hold about £1m of bonds. This is about 0.7% of their portfolio. They would be able to screen out individual tobaccos from direct holdings, but could not do this for mutual funds. Whilst they could do this it would be viewed as a constraint on their abilities.

12 HYMANS ROBERTSON

The full Hymans Robertson opinion is attached at Appendix 1.

They believe that Funds are only entitled to make decisions based on financial interest. Any attempt to exclude tobacco stocks would only be possible if a legal opinion was obtained which said this was permitted.

Their view is that investment decisions should be made by the Fund managers and that tobacco stocks have out-performed.

13 CONCLUSION

Whilst the Fund managers would be able to continue investing without holding tobacco stocks, it is unclear whether the Sub-Committee have the powers to instruct this. Hymans Robertson are quite clear that legal opinions must be sought and even if obtained it may be subject to challenge.

In addition, it is noted that had the Fund had this policy in place over the last three years there would have been a loss of funds.

It is therefore felt that Hymans Robertson's recommendation is appropriate and that current practice should be continued with no specific exclusions.

14 BACKGROUND PAPERS

None

DAVID K DORWARD
DEPUTE CHIEF EXECUTIVE (FINANCE) **15 FEBRUARY 2005**

Disinvestment from Tobacco Companies

Introduction

We have been asked to give our advice on the likely impact of withdrawing from investments in Tobacco Companies and, if it were to be done, how the process should be managed. In our remarks that follow we describe, inter alia, what we believe to be the position regarding the powers of the Council to take such a decision. We are not qualified to advise from a legal perspective and we would advise that the Council should obtain a legal opinion before proceeding to disinvest from Tobacco Stocks if that is what it wishes to do.

Background

The Tayside Superannuation Fund is divided into two funds; a general fund for the employees of all employers other than those of the Bus Company and the Transport Fund, which is run exclusively for those former employees and their dependents of the former Municipal Transport Undertaking that were transferred to Travel Dundee on privatisation of the Transport Undertaking. However, both funds share a common set of investment management arrangements through a unitised pooling arrangement so that guidance or instruction given to the investment managers affects both funds.

Dundee City Council is the Administering Authority for the Tayside Superannuation Fund(s) and the City Council has delegated the responsibility for supervising the investment arrangements of the Fund(s) to the Superannuation Investment Sub-Committee. The elected members of Dundee City Council that serve on that Committee are not Trustees of the Superannuation Funds, which, being part of the Local Government Pension Scheme [LGPS], established under the Superannuation Act 1972, is a statute based scheme. However, it is widely accepted that elected members serving in the capacity described have the same fiduciary duty to act in an equitable way between all those that have an interest in the Superannuation Funds as they would have had they been trustees of a pension fund established by trust deed. In some respects that fiduciary duty rests more onerously on elected members serving as quasi trustees in the LGPS because the Fund's liabilities are ultimately underwritten by the revenue raising ability of the City Council. This means that the local taxpayers also have an interest in the Fund(s).

There is, in our view, no other basis for taking decisions regarding the Superannuation Fund(s) than the common financial interest of those persons with an interest in the Fund(s). It is believed that the only common interest, and the interest which the quasi trustees must apply equitably to all persons having an interest in the Fund(s), is a financial interest.

Investment Management Arrangements

Although it would be within the powers of the Superannuation Investment Sub Committee, subject to the taking of appropriate advice, to take investment decisions themselves, they have delegated investment decision making to professional investment managers.

Following best practice as described in "Principles for Investment Decision Making in the Local Government Pension Scheme in the United Kingdom" published by the Chartered Institute of Public Finance and Accountancy [CIPFA Pensions Panel Guidance Note No 5, April 2002] and in accordance with the common approach to these matters, the Sub Committee have given those investment managers clear investment mandates that include a definition of the types of securities that each manager may invest in and they have set recognised benchmarks against which managers' performance is to be judged. Managers have also been told the level of superior performance that they are expected to achieve relative to those benchmarks and the period over which that achievement or otherwise will be judged. There is an expectation that this level of performance will be achieved within a framework that takes some risk but that also controls the level of risk taken to suitable levels.

The Sub Committee has not chosen to express a view on the merits of one security or group of securities against another security or group of securities in terms of the likelihood of a superior or inferior return over any given period of time. This too would be the approach most commonly adopted by Trustees or of pension or superannuation funds.

The reasons why delegation generally does not constrain investment managers' activities regarding securities selection include:

- Firstly, most groups of Trustees are not regularly active in the financial markets and can in general claim no expertise in stock selection as regards likely financial outcomes.
- Secondly, it would appear to negate the purpose of appointing a professional manager if his professional judgement is to be constrained by instructions that are not based on the financial outlook of particular securities but on some non financial basis.
- Thirdly, most groups of trustees have no mechanism for keeping such judgements under day to day review to ensure that they have not become less relevant or pertinent in current conditions.

As an aside, it may be thought that there are stocks or groups of stocks where it is obvious that their financial performance may tend to be weak and it may be considered that Tobacco stocks, facing as they do, potential large third party liability claims from consumers of tobacco products in some developed countries, fall into that category.

However, even stocks such as these may well deliver superior performance from time to time as Appendix 1 shows in the case of Tobacco stocks. In the four year period to September 30th 2004 Tobacco stocks outperformed the general market in all markets. In all markets apart from

Japan the level of superior performance was markedly strong and the superiority of performance was persistent from quarter to successive quarter, particularly in the UK market.

Trustees that have delegated the generality of stock selection decisions to professional managers and who are not able to claim particular experience in stock selection matters may be thought to be acting out of reasons that are not based in financial considerations if they decide that certain stocks or types of stock will be excluded from the investible universe. Their position would also be weakened since it is not general practice for Trustees to make decisions on specific stocks.

Such trustees might be considered not to be properly discharging their fiduciary duty to those with an interest in the fund and could well be regarded acting outwith their powers. Though it may in practice be thought unlikely such trustees may be subject to challenge to account for their decision and the financial consequences that flow from that decision.

Practical Considerations

In practical terms the exclusion of tobacco stocks from an investment manager's universe is unlikely to have any significant effect on their ability to deliver the performance demanded by the Sub Committee even in those periods when Tobacco stocks outperform the indices. In the UK, for example, the three Tobacco stocks accounted for only 1.9% of the FTSE All Share Index at September 30th 2004. Nor are tobacco stocks a significant feature of any other mainstream market. There are almost 700 stocks in the FTSE All Share Index and managers will not generally hold more than 100 of them. In principle there should be plenty of opportunity left to managers to select replacement stocks with equally good short term prospects. Moreover, as will be seen from Appendix 1 there are periods when Tobacco stocks under perform and it would pass without remark in these periods if the manager did not hold these stocks, even from a risk control point of view.

However, should the powers of a decision to exclude Tobacco stocks from the investible universe be challenged those making the challenge might well claim as a loss attributable to the decision to exclude Tobacco stocks the contribution that those stocks would have made to performance had they not been excluded. In absolute terms these numbers could be significant.

To take the twelve months to September 30th 2004 as an example, we have estimated that had managers simply held Tobacco stocks in their portfolios in the strict proportion of tobacco stocks to the market as a whole, and applying the excess return from each market to those holdings, the fund would be just under £1m better off than had it not held tobacco stocks. The year in question is by no means the best year for excess returns from tobacco as will be seen from Appendix 1.

Implementation

Implementation of a decision to exclude Tobacco stocks from the investible universe would, in principle, be quite straightforward. Ideally managers would be informed that the Sub Committee wished them not to hold the stock from a date stated in the future – perhaps six or twelve months to allow an appropriate period of notice for managers to choose with flexibility the timing of any sales to exit existing holdings. After the stated date such stocks would be banned from the portfolios. In fairness to the managers, the benchmarks should be adjusted to reflect the ban on holding tobacco stocks and in order that the effect of the Sub Committee's decision was transparent [i.e. by comparing the return on the benchmark excluding tobacco stocks with the normal (inclusive) benchmark] and to enable the Sub Committee to be accountable for the effects of the decision.

Conclusion and Recommendation

In conclusion:-

- Our understanding is that this is not a common approach and that some administering authorities that historically imposed a ban of this nature have since removed that ban.
- We would question whether the imposition of a ban on holding tobacco stocks is consistent with the Sub Committee's fiduciary duties.
- We believe that there is a risk, albeit a small risk, that such a decision would be challenged and if the challenge was upheld elected members responsible for taking the decision may be liable for any loss.
- In any event, defending a challenge could be a costly and time consuming affair
- We would strongly advise that a proper legal opinion be obtained before any decision to disinvest was implemented.
- However, in practical terms we do not believe that a ban need have significant investment consequences.
- We believe that a ban could be relatively easily implemented.
- Implementation should include an adjustment to the benchmarks to reflect the decision and to facilitate transparency.

Our **recommendation** is that the current practice whereby the managers are set benchmarks that in general reflect the investible universe is maintained and that no specific exclusion be applied.

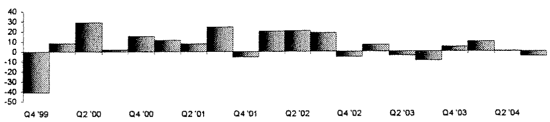
Prepared by:-

S G Singleton
Russell Borland
16 December 2004

Appendix – Performance of Tobacco Stocks

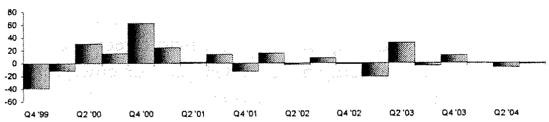
Relative Performance (p.a.)

UK Tobacco performance relative to the market



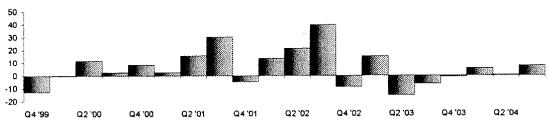
	1 year	2 years	3 years	4 years	5 years
Q3 '00	-15.7				
Q3 '01	73.1	20.7			
Q3 '02	63.1	68.0	33.5		
Q3 '03	-12.0	19.8	35.4	20.3	
Q3 '04	10.0	-1.6	16.4	28.6	18.1

US Tobacco performance relative to the market



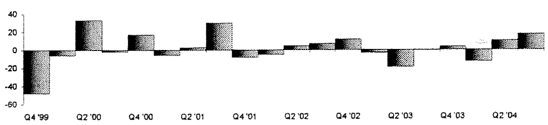
	1 year	2 year	3 year	4 year	5 year
Q3 '00	-18.9				
Q3 '01	135.5	38.2			
Q3 '02	6.7	58.6	26.8		
Q3 '03	-2.6	2.0	34.8	18.7	
Q3 '04	1.7	-0.4	1.9	25.6	15.1

Europe (ex UK) Tobacco performance relative to the market



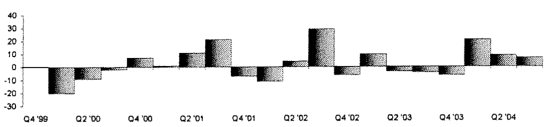
	1 year	2 year	3 year	4 year	5 year
Q3 '00	-0.1				
Q3 '01	68.6	29.8			
Q3 '02	83.9	76.1	45.8		
Q3 '03	-16.6	23.8	37.2	26.8	
Q3 '04	13.1	-2.9	20.2	30.8	23.9

Japan Tobacco performance relative to the market



	1 year	2 year	3 year	4 year	5 year
Q3 '00	-35.7				
Q3 '01	47.8	-2.5			
Q3 '02	-2.9	19.8	-2.6		
Q3 '03	-12.6	-7.8	7.9	-5.2	
Q3 '04	17.0	1.1	-0.2	10.1	-1.1

Pacific (ex Japan) Tobacco performance relative to the market



	1 year	2 year	3 year	4 year	5 year
Q3 '00	-28.3				
Q3 '01	45.7	2.2			
Q3 '02	11.5	27.4	5.2		
Q3 '03	-5.3	2.8	15.4	2.5	
Q3 '04	31.6	11.7	11.6	19.3	7.7