Draft response to the DCLG's consultation on opportunities for collaboration, cost savings and efficiencies in the Local Government Pension Scheme.

Q1. Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments? Please explain and evidence your view.

Common Investment Vehicles could allow some funds to achieve economies of scale and deliver savings. For one of our active global equity strategies a £100m mandate might cost 0.35% p.a. using a typical tiered fee scale, while a £1bn mandate in a CIV and including the assets of a number of underlying authorities might cost 0.30% p.a.

It should be noted that the main beneficiaries of such aggregation would be the smaller authorities such as some of the London Boroughs. Many County schemes are already of a size that enables them to benefit from economies of scale. Any further fee savings through aggregation would be marginal for these funds.

A CIV is however not the only way funds can achieve this sort of savings. The Northamptonshire and Cambridgeshire Pension funds (with assets of circa £4bn), without using CIVs and discussing with managers where they share mandates are already able to aggregate fees in this manner because of the buying power of the two funds under LGSS.

Also, most fund managers that service the LGPS are already aggregating fees on a tiered scale to LGPS funds that have the same mandate with them or are in the process of rolling out that option as a solution. There is a collective pressure on the investment management industry global to be more fee sensitive and there is no doubt that the debate engendered through the call for evidence process has helped contribute to that. In essence, the general direction of fees in investment management is lower across the globe.

There are however some practicalities to iron out to make the tiered fee structure more potent for the LGPS, primarily standardising Investment management agreements (IMA). These practicalities are however less onerous than the ones surrounding CIVs (which are in essence 'pooled funds').

Several managers have indicated a willingness to engage with a CIV on the terms that the investors (i.e.LGPS funds) are invested in a single strategy and the managers' report to a single entity. This therefore suggests that any CIV structure has to be robustly set up with the ability to assume fiduciary responsibility for the performance of the strategies and managers invested in it. To operate, It also has to be able to report back to local Pension Fund Boards or Investment Sub Committees since the DCLG has indicated that strategic asset allocation will continue to sit locally, administer and account for assets, monitor managers and structures, perform due diligence, manage the taxation process, etc.

In essence, a CIV is likely to replicate existing pooled fund or tiered fees arrangements without delivering any savings over and above the quantum possible with less risky solutions.

Savings in asset classes such as hedge funds and private equity where fees tend to be multi layered and higher could be significantly greater if a CIV were to be used. Chart 1 on page 11 of Hymans Robertson's report shows that 40% of overall fees are spent on just 10% of assets.

A CIV does however still replicate the same 'fund of funds' strategy currently prevalent across the LGPS in accessing alternatives. This is the idea of paying a fund manager to invest assets in other fund managers either for access or diversification reasons. It's the multi layered fee approach in these asset classes that makes the fee quantum so great.

To deliver any benefits in the alternatives space, a CIV will have to have the ability to research, engage and access the best alternative funds. These funds when capital raising are often already over subscribed and limit access to existing clients. For an LGPS CIV to make any headway in this space, it will necessitate going down the route of investing directly like other large public sector pension funds (e.g. the Canadian Pension Plan or the Dutch public sector fund – APG).

These funds source, do due diligence and invest in alternative asset classes directly. They are able to do this by resourcing their in house teams adequately (with market rate remuneration) and offices around the globe. Both funds above have assets in the region of the combined value of the LGPS and although Canadian and Dutch, have offices in London and New York in order to efficiently access the best risk adjusted returns on deals. In essence, they are commercially structured and commercially run in order to deliver on the objectives of providing sustainable retirement income to their members.

A successful LGPS CIV will need to be commercially structured and commercially run if it is to deliver on the same objectives.

To clarify, we believe that a CIV structure for listed securities will deliver minimal or no benefits and is even likely to be more costly and more risky to set up and manage than other simpler options like tiered fees. However in the alternative space, collectivisation for the LGPS in a vehicle that is properly resourced and commercially structured has the potential to deliver benefits as long as it's not another 'fund of funds' manager. Assuming the typical LGPS fund holds 10% in alternatives like private equity or infrastructure, this will suggest a pooled quantum of circa £18 billion for the LGPS, which if invested directly can start to access better risk adjusted deals in the alternative space globally.

Most funds currently try to access those sorts of deals hence the use of fund of fund managers. If the 10% allocation to alternatives is collectivised in a commercially structured and well resourced CIV vehicle, then benefits could accrue from that.

Q2. Do you agree with the proposal to keep decisions about asset allocation with the local fund authorities?

This question is of critical importance to the success of any future structure of the LGPS and needs to be well thought out.

It is a well established fact that the bulk of investment performance is driven by strategy (i.e. asset allocation). If the DCLG accept this and if they also believe that some funds are underperforming or not well run, then it almost seems bizarre to leave the most important driver of investment performance in the same local fund authorities' hands.

The importance of a good decision making structure or 'governance' cannot be underestimated and is the crux of any failings within the LGPS.

The governance 'dividend' or the benefits of better decision making if applied across the LGPS could in the first instance bring the performance of the lower performing Funds up to the average. This would deliver financial returns that would dwarf the potential cost savings identified by Hymans Robertson in their report.

The report for London Councils by PwC in October 2012 highlighted potential gains from savings and enhanced performance of up to £120m p.a. for the £24bn of assets managed by London alone, with £84m p.a. (70%) being due to better performance and £36m (0.30%) due to cost savings.

70% p.a. extra performance from applying better governance and learning from the best, if applied to just half of the £180bn assets (in other words the lower performing half) in the LGPS, would lead to £315m extra returns p.a.

Applied across all of LGPS assets this would lead to £650m extra p.a. If the 0.70% could be raised to 0.85% p.a. it would mean an extra £900m p.a. This governance dividend comfortably exceeds the total of all investment costs of £790m (from the consultation, paragraph 2.5)

Although this may seem ambitious, an improvement of 0.5% p.a. would not even raise those in the lowest quartile of returns (Table 10, page 21) up to a median level of performance.

Reducing the best back to the average (which will surely raise council taxes in those boroughs/ counties) will not help.

An option may be for the DCLG to consider putting consistently underperforming funds in 'special measures' like it's currently done with failing schools. What 'underperformance' means will need to be clearly defined as it isn't as clear cut as less than average investment returns in comparison to peers. To illustrate, if a fund decides to adopt a liability hedging strategy using index linked gilts, it is likely to underperform all its peers who decided to invest more in growth assets for deficit reduction purposes (especially in a bull market).

Coming back to the concept of 'special measures', once a fund is identified as underperforming, then its asset allocation decision making ability can be taken away and passed on to another fund to manage (exactly the way OFSTED and the Department for Education manage failing schools). This way, there is a better chance of achieving this 'governance dividend' across the LGPS leading to improved performance.

(Extra paragraph or two here highlighting the improvements in governance that our two funds have made since coming together under LGSS. Also link/evidence the benefits of the improved governance to the improvements in asset returns for both funds).

Finally, although others are better qualified than us to comment on democracy and local accountability, it would however seem inconsistent to also allow administering authorities to retain the decision over asset allocation (the most important driver of performance as stated earlier) whilst not allowing them to decide how much of their listed assets should be managed passively and how much actively.

Q3. How many common investment vehicles should be established and which asset classes' do you think should be separately represented in each of the listed asset and alternative asset common investment vehicles?

When considering how many vehicles should be established it is important to recognise that in investment there are diseconomies of scale as well as economies. Big is not necessarily better.

We agree with the comments in paragraph 4.10 on page 19 of the Consultation. We believe that most investment strategies have a natural ceiling to the amount of assets that can be actively managed before diminishing returns start to apply In fact, our better performing mandates have been closed to new investors for this reason (examples include the Majedie UK equity fund that has been closed for over 3 years with a capacity of £7bn or the Baillie Gifford Diversified Growth fund that has been closed for over a year with a capacity of £6bn).

Therefore, CIVs should be sized and structured in such a way as to allow them to achieve exposure to those managers with closed strategies, acknowledging that many of the best managers will limit capacity in these.

To illustrate this point further, both examples given above have mandates from both corporate and public sector funds all over the world invested in these two funds. So they are not only LGPS centric. If an LGPS CIV intends to hold the best of breed managers and these best of breed managers close their funds to limit capacity so they can continue to maintain performance and remain best of breed, then having a £180bn collectivised means that there is a limit that any CIV can have in the best strategies that have a £6, £7 or £10bn capacity (including inflows from around the world). So the optimum number of CIVs needs to take account of this.

This question should however be evaluated in line with our responses to questions 1 and 2 above. To reiterate, we don't believe that there is any benefit from collectivising in the listed securities space using a CIV.

Any benefits of collectivisation are likely to result from the alternative asset classes' space (private equity, infrastructure, hedge funds etc). These benefits can only be potentially achieved if the CIVs for alternatives are commercially structured (including their governance arrangements), commercially run and well resourced (people with the right skills, temperament, attitude, values and expertise to structure private equity or infrastructure or hedge fund style deals the way other global public sector pension funds like the Canadian, Dutch or Australian Pension funds do) in order to invest directly in those alternative asset classes.

Practically, CIVs can be established to cover global equities, UK equities, UK Government bonds (fixed income and inflation linked), investment grade corporate bonds, diversified growth, hedge funds, infrastructure and private equity. There should be active and passive options for each to suit individual fund choices but the benefits of collectivisation are only likely to be achieved following the template articulated above and in response to questions 1 and 2.

Q4. What type of common investment vehicle do you believe would offer the most beneficial structure? What governance arrangements should be established?

A CIV needs to have the following characteristics:

- Appropriate for professional institutional investors to pool assets
- Capable of supporting a range of separately or co-managed ring fenced sub funds
- A flexible regulated investment fund vehicle adapted to any type of investment strategy
- Cost efficient
- Manageable capital considerations
- Appropriately regulated
- Assets held by an appropriate custodian/depositary
- Tax efficient with regard to any capital gains or income tax at fund level.
- Appropriate access to Dual Tax Treaties for the purpose of minimisation of Withholding Tax
- Cost and tax efficient in-specie transfer of assets into the vehicle.
- Suitable for a wide range of investment strategies including those involving conventional and alternative assets

There are five main CIVs available in the UK [listed below]:

- Life companies (Life wrapped OEIC) (OEIC is ‘Open Ended Investment Company’
- UK authorised funds (OEIC or Authorised Unit Trust)
- UK unauthorised unit trusts (UUTs)
- Pension Fund Pooling Vehicle (PFPV) or Common Investment fund (CIF)
- UK Authorised Contractual Scheme (ACS)

Key features of potential pooling vehicles

	ACS	Life wrapped OEIC	OEIC	CIF or PFPV
Country	UK	Luxembourg / Ireland	Luxembourg / Ireland	UK
Taxation of fund	Nil	Nil	Nil	Nil
Tax transparency	Tax transparent	Tax transparent	Not transparent	Not all countries view as transparent
Tax treaty access	Yes, including Japan	Yes, not Japan	Not in most countries	Depends. Not always clear
VAT on management fee	Exempt	Exempt	Exempt	VAT charged
Regulatory	Regulated	Regulated	Regulated	Not regulated
Sub-funds bankruptcy remote	Yes	Yes	Yes	Unclear

To this end we would consider regulated co-ownership tax transparent pension fund vehicles to be the most appropriate. A UK domiciled and FCA authorised Co-ownership Authorised Contractual Scheme (ACS) structured as a Qualified Investor Scheme may be a suitable option. The Stamp Duty Reserve Tax exemption, introduced in the UK to help facilitate investment in ACSs, makes this vehicle currently very attractive.

The subject of governance as stated earlier is the critical consideration in terms of the future success and sustainability of the LGPS.

Establishing a CIV should have three main objectives. It is important that the governance arrangements reflect this. The high level objectives as we see them are:

- **Improving net returns -** The CIV should have the resource to select “best of breed” managers and monitor those managers collectively. This may require the CIV to act as a “manager of managers” offering strategies run by a small pool of complementary managers (please see response to question 1).

- **Reducing costs** - Reducing investment management fees by pooling assets and thereby obtaining better commercial terms (please refer to question 1’s response).

- **Streamlining governance** – Please refer to question 2.

To fulfil these three objectives a CIV will need to have an appropriate investment committee. This could be drawn from appropriate Officers and Members together with professional advisors. If a CIV does not have such an investment committee, not all the benefits may be realised.

Getting the balance of investment choice on CIVs is crucial. Too little choice and Schemes would not use them, too much choice and there will be little or no saving in resource at individual scheme level, fee savings would be diluted and returns from improved governance of schemes and better manager selection would be limited.

Q5. In light of the evidence on the relative costs and benefits of active and passive management, including Hymans Robertson's evidence on aggregate performance, which of the options set out above offers best value for taxpayers, Scheme members and Employers?

The first two options would amount to an acceptance of mediocrity. The most obvious explanation for these two options being proposed is a response to the numerous academic and empirical studies which show that the 'average' active manager has, after fees, underperformed the index over most periods of time. Supporters of passive management point to this as evidence that active management does not add value.

The flaw in this argument is that it refers to the 'average' manager. Apply the same logic to other walks of life: the average golfer does not win the Open Championship, the average writer does not pen a classic and the average painter can't be expected to produce a masterpiece. So why should anyone anticipate high investment returns from the average fund manager?

The case for active management rests on avoiding the average manager. If we took out the value added net of fees that the bulk of our active managers have added to the two funds over the past 5 years, they both will be in a much worse position with regards to funding levels and deficits.

As an example, relative to passive management, we would be approximately £60 million per year worse off (£300m over the last 5 years) across the two funds. This is the value of outperformance net of fees to us over the period from using active management. Using the Majedie UK equity fund as a specific example, in the 5 year period, the FTSE 100 will have earned us £70m. The Majedie active UK Equity fund earned £151m net of fees for the same period.

If we took the outperformance net of fees for the two funds from active management out, employers, scheme members and tax payers will have needed to consider increased contribution rates.

There are also other considerations around passive investing including the fact that investing in a benchmark is not without risk and there is significant value in avoiding large parts of the market that passive investors blindly hold. For example, the technology bubble of the late 1990s and the recent banking crisis provide painful evidence of the risks attached to blindly tracking the market.

Currently, if funds invested passively in global equity (MSCI World is the index), there will be a disproportionate exposure to US stocks which most active investors regard as being up to 70% overvalued and due a correction. (Elaborate more on the risks/return issues surrounding these two options. Also include facts around most LGPS funds already invest some of their assets passively. Also include point that this is the default position unless an active manager can be found that can deliver value over and beyond passive management net of fees).

The ‘comply or explain’ option may be the best chance to improve outcomes and offer best value for taxpayers, Scheme members and employers, although only if Funds were being asked to comply with the investment approaches that have proved to be the most successful over time.

The fourth option – effectively the status quo - should not be discounted. Most Funds, including the best performing ones, have already considered the benefits of passively managed listed assets and many have allocations to both passive and active managers.

The experience of many LGPS Funds is that active management can add value net of fees and transaction costs. Hymans Robertson identified the characteristics of the most successful funds (in Appendix 2b of their report).

The long term nature of the LGPS should enable administering authorities to adopt these characteristics, meaning there is no reason why the returns of the LGPS in aggregate shouldn’t exceed those of the market as a whole.

We are not surprised however by Hymans Robertson’s finding that returns across the whole LGPS in aggregate have been similar to those of the index. It is well known that the active management industry as a whole has not provided outperformance commensurate with its fees, but we do not think this is an indictment of all active managers and nor should it be a reason for the LGPS to settle for mediocrity.

Rather, it again reflects an issue of **governance.**

A lack of focus on the observable characteristics of managers who do outperform over the long term, as outlined by Hymans Robertson, has led to poor decision making on the hiring and firing of managers. These characteristics include:

- Long term outlook, retaining their managers though periods of underperformance and not hiring and firing at the wrong times;
- Simple structure, few managers;
- Some use of internal management, including passive; and
- Relatively little use of high fee alternatives.

This is also supported by a host of other academic studies (such as Petajisto & Cremers, Mauboussin and others) which support the following.

- Genuinely active, index agnostic managers perform better than passive managers, net of fees;
- A focus on value for money (returns net of fees, not costs alone) helps;

- Low turnover, meaning lower transaction costs, can lead to better long term returns.

This is consistent with our own beliefs and experience (Majedie, UBS UK Equities, Schroders UK Equities, Skagen and Baillie Gifford).

Consultants should learn from these experiences as well. While some have encouraged simplicity, value for money and a long term outlook, others have replaced active managers after short periods and at the wrong times and introduced more complicated mandates involving higher fee asset classes to little overall effect. Many have struggled to identify the better performing active managers over time despite the academic evidence referred to above.

In our experience, we note that more use of experienced, independent advisers with no incentive to generate activity in the form of manager searches or strategy reviews may protect against these shorter term commercial pressures and improve the governance of individual schemes and common investment vehicles.

Conclusion:

Improved governance leading to a focus on replicating the characteristics of the most successful LGPS funds would deliver best value for taxpayers, Scheme members and employers. Improvements in investment returns, net of fees, are achievable and could dwarf the potential cost savings that were identified in Hymans Robertson's report.