<u>Tri-Borough Consultation Response</u>

The City of Westminster, London Borough of Hammersmith & Fulham and the Royal Borough of Kensington and Chelsea have been managing their respective pension fund investments for over two years as part of a Tri-Borough initiative, in part to reduce costs for the three councils. The funds remain sovereign in their decision making and asset allocation processes but considerable efficiencies and greater resilience in service provision have been achieved through the joint administration arrangements. Hence, we consider ourselves well placed to offer our views on the consultation on *The Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies* and we welcome this opportunity to respond.

We note that following the Call for Evidence carried out last summer, the work commissioned by CLG last autumn, the subsequent report from Hymans Robertson and this Consultation that there have been significant discussions on the structure of the LGPS which could have far reaching consequences. We welcome the substantive nature of the discussions and understand the importance of considering a broad range of ideas and approaches. The objective should be to reach agreement on a structure that will provide long term stability on a sustainable basis, rather than a quick-fix which may achieve short-term savings but at the expense of asset growth in the longer-term.

Before discussing the current consultation, we would like to consider some of the points made in the Government's response to the Call for Evidence on the future of the LGPS. The maintenance of the link between a fund's asset allocation and local determination is a key plank of local democracy – given the local impacts of the costs that would fall on the administering authority.

While the two primary objectives listed last summer were dealing with deficits and improving investment returns, the current consultation adds the reduction of costs and greater efficiencies.

We note that the Shadow Board will be asked to continue to explore options for dealing with deficits and trust that considerations such as these will be taken forward in the best interests of the LGPS as a whole.

The objectives for improving investment returns and the reduction of costs are not necessarily aligned because although passive management fees are undoubtedly cheaper, the higher costs of active management are often far outweighed by the higher returns achieved. The return <u>net of fees</u> is therefore the most important consideration. This is not only the case in rising equity markets. When markets fall, it is inevitable that the fund's loss will be commensurate with the market fall if the assets are passively invested. However, a good active manager should be able to protect a significant proportion of a fund's assets by switching into more favourable sectors or other asset classes.

There has been much discussion of whether size is a factor in generating better returns and outcomes. At best, these arguments have been inconclusive, with some

small and some large funds performing very well while others of similar size languish lower in the league tables. Rather than size, it is likely that the strength of knowledge on the pension committee and the overall quality of the governance arrangements are determinants of performance.

Under the Tri-Borough arrangements, we have found greater efficiencies and significant advantages in the running of three funds which, though segregated, can all benefit from the sharing of ideas, discussion of strategies, reduction in costs and improved oversight. While this is noted in the current consultation, we believe there is more to be gained in this area from the adoption of similar approaches elsewhere, than is given credit for in the current Consultation.

This leads on to the current Consultation on the LGPS. We note that while the current consultation is focusing on fees, we firmly believe (as we demonstrate below) that the focus should be on outperformance over a relevant benchmark, net of fees. Focusing on the absolute level of fees may provide some understanding of costs the more relevant and useful information is what value is actually being added to the funds through the particular strategy. In some cases, the costs may be greater but these may be justified by higher returns. This last point seems to have been lost in the recent analysis by Hymans Robertson.

Turning to the questions posed in the current Consultation:

1. 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.

Collective (rather than Common) Investment Vehicles (CIVs) are indeed a way for some funds to achieve economies of scale and deliver savings for a range of asset classes, but there is also a governance benefit (depending on how they are structured). The Tri-Borough Funds are working closely with London Councils and are supportive of their proposals for a London CIV. This proposed CIV is expected to be an effective model given the similar sizes of pension funds, the proximity of locations which facilitates joint meetings, as well as similar structural backgrounds of many London boroughs. Tri-Borough officers have been extensively involved in setting up the London CIV which is expected to be operational in 2015. The proposed London CIV will be available to London LGPS funds on a voluntary basis, ensuring that the individual pension committees retain the right to invest in the most effective and beneficial manner as they see fit.

The Tri-Borough Funds firmly believe that CIVs would allow groups of funds to achieve economies of scale and deliver significant savings. Within Tri-Borough, some managers have already aggregated fees where two authorities have the same mandate and there is every reason to expect that by coming together with other funds (through a CIV), further savings could be achieved.

Looking further ahead, CIVs could provide opportunities to pool resources and have far stronger governance over illiquid and often fragmented asset classes such as

private equity and infrastructure. Long-term investments such as these are well suited to the liability profiles of pension funds, but require specialist knowledge which would be best paid for collectively. At present, the main way of investing in these asset classes tends to be through fund of funds structures.

There are other ideas that could be considered alongside CIVs, where some large funds undertake a significant amount of asset management in-house (especially outside London). Such funds could provide services such as passive management to other LGPS funds. The legal vehicle of such an offer may have to be via a CIV for technical reasons, and that may have to be a different structure to the proposed London CIV. There may also need to be changes to regulation to allow one LGPS fund to manage assets on behalf of another LGPS fund.

As it is early days in the development of the CIV structure, we do not believe it is appropriate to set out in regulation a "one size fits all" model.

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

Yes. Asset allocation is a key decision taken by each pension committee and an important means of managing pension fund cashflows and deficits. It is also important that the decision regarding the use of active or passive management (itself a subset of asset allocation decisions) is made at the local level, since different types of investments will be appropriate for schemes with different membership profiles and funding levels.

3. 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?

We do not have a fixed view on how many collective investment vehicles there should be, but there should be enough to make investing effective and efficient. There may be some geographic constraints to consider when establishing CIVs if governance and efficiencies are to improve as a result of the CIV structure. There are three key issues which determine our view on the number of collective investment vehicles:

Governance – To work effectively for the benefit of the LGPS, there needs to be a strong governance structure in place for any CIV. The larger the CIV, the more robust the governance structure needs to be. Given that funds will still be responsible for investment strategies locally, it is crucial they are able to input into the direction a CIV takes.

In London, this is being achieved by establishing a joint committee of elected members who represent the participating boroughs and have oversight of the CIV. This ensures that local democracy feeds through to the CIV and that the investment needs of the boroughs are met by the structure.

The geography of the CIV is important in this regard given that meetings with managers and other funds in the CIV may be more effective where held in person. For example, a CIV established in the North East may be of limited benefit to funds in the South West.

If there were to be only one or two CIVs nationally, not all Funds would be able to have representation and the local democratic input would be significantly reduced.

Capacity – As we set out in our response to the Call for Evidence, many of the best managers have a natural ceiling to their investment strategies and close to new business in order to protect this. This ensures that diminishing returns do not result from the market impact on price, which can happen when managing a large value of assets. If a small number of CIVs each of significant size were introduced, there is a risk that the best fund managers may not offer their best products because of this capacity issue.

Competition – In order to ensure that the LGPS continues to get the best possible deals from the industry, it is important to ensure there is competition. A monopoly situation of just one CIV is unlikely to lead to competitive pricing and value for money for the LGPS. However, if a number of CIVs were operating, comparisons between them would be possible, enabling the LGPS to put further pressure on the industry to deliver value for money.

It is our view that each CIV should offer all asset classes which the participating funds require and for which there is a clear benefit through the CIV structure. The structure of the proposed London CIV allows it to offer a range of asset classes through a series of sub funds. Therefore it is not necessary, or desirable, to have one CIV per asset class.

The London CIV is expected to have sub-funds representing different asset classes and will be driven by the needs and requests from the participating boroughs via the joint committee. This structure ensures the CIV remains relevant to the investment strategies which are being set locally.

The London CIV is also being set up on a voluntary basis, so that funds can still invest outside the CIV where this is more beneficial to them. It is our view that this flexibility is essential to enable LGPS funds to maximise their investment return and ultimately meet their liabilities.

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

Following the work undertaken by London Councils, we believe a CIV needs to have the following characteristics:

- Appropriate for professional institutional investors to pool assets;
- Capable of supporting a range of separately managed sub funds;
- Efficiently run and cost-effective;
- Appropriately regulated;

- Have assets held by an appropriate custodian/depositary;
- Tax efficient with regard to any capital gains or income tax at fund level;
- Give appropriate access to Dual Tax Treaties to minimise Withholding Tax;
- Suitable for a wide range of investment strategies including conventional and alternative assets.

As London Councils developed the work to set up the London CIV, they have taken external advice from experts in the fields of tax, law, asset servicing and had discussions with HM Treasury. This has led to the conclusion that a UK Authorised Contractual Scheme (ACS) is the most appropriate (if not, only) vehicle for a LGPS CIV.

The Tri-borough funds are represented on the London CIV working group so we have a good understanding that alternative structures are less attractive. An ACS is regulated by the Financial Conduct Authority, is tax transparent, enables the accessing of different asset classes and it is an on-shore UK based vehicle.

An appropriate governance structure would depend on how and where the CIV is established. In London, it has been agreed that this is best delivered through the Joint Committee. This ensures that local democracy flows through to the CIV and the development of what is offered is driven by the investment strategies of the participating boroughs.

5. 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 decision of whether to invest on an active or passive basis is an integral part of asset allocation and the setting of an investment strategy for a Fund. The consultation states at paragraph 4.8 that "all asset allocation decisions should remain with the fund authorities". We believe this should include the decision of whether the management of the assets is on an active or a passive basis.

The Tri-Borough funds invest the majority of their assets on an active basis. We believe that long-term active asset management can play a key role in reducing deficits and contribution levels. We do not think it will be possible to eliminate fund deficits through passive management alone. The three pension Committees of the Tri-Borough funds have extensive knowledge and understanding of investment matters enabling them to make informed decisions and monitor effectively their investment strategies and the managers they have selected. This experience leads to good governance which has ensured the active strategies have been successful over long periods.

For example, the Royal Borough of Kensington and Chelsea pension fund has invested in active management strategies for over these 20 years. The returns from one active manager have exceeded the performance benchmarks by 1.6% per annum. Over the 20 years, this investment has earned the pension fund £196

million, net of fees. Had the funds been invested on a passive basis, the pension fund would have earned only £126 million – £70 million less than the active return.

The Hammersmith & Fulham and Westminster funds have invested with another manager on an active basis, since 2005. In this time these investments have earned £65 million and £68 million respectively over the index, net of all fees. This is double what would have been returned had the funds been invested on a passive basis.

For all three funds, this active return (net of fees) is significant added value, which has assisted in the reduction of the respective deficits.

Active management of assets is not just confined to portfolios of only equities or bonds, there are other investment options for funds to manage risk on an active basis and in particular protect against downturns in markets.

For example the Hammersmith and Fulham fund invested with a diversified fund manager on an absolute return basis in August 2008. During the following eight months, the FTSE All Share fell 26.8% while the fund delivered a positive return of 12.7% for Hammersmith and Fulham net of all fees. In total over the whole of the period Hammersmith and Fulham have invested with them the return net of fees has been 78.3%, whereas the FTSE All Share has returned only 56.2%. This demonstrates how difficult it is for passive investments to recover from a period of market underperformance.

Restricting LGPS funds' ability to invest in active management would have the, perhaps unintended, consequence of limiting the options for funds to manage risk through other investment options. If funds had a requirement to use some passive management, this would be a forced importing of risk to the fund's strategy. Investing passively or actively is not mutually exclusive, and indeed two of the Tri-Borough funds have taken a decision to be invested in both active and passive listed equities at the same time.

Passive management can be effected through a number of different indices and approaches. The consultation provides no definition of passive management and so it is not clear what range of approaches are considered appropriate.

LGPS funds are required to explain what the investment strategy is, and why, through the Statement of Investment Principles. It is in this document that a Committee's investment decisions are explained, and we believe this is the most appropriate document to state the decision whether to invest actively or passively.

This would enable the funds with the appropriate governance in place to continue to invest on an active basis where it is in the best interests of their fund and where value can be added.