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SOUTH YORKSHIRE
**PENSIONS AUTHORITY**

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Financial Conduct Authority

Steve Pick CPFA
*Clerk and Treasurer*

18 Regent Street
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South Yorkshire
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# NOTICE OF AUTHORITY MEETING

**You are hereby summoned to a special meeting of the South Yorkshire Pensions Authority to be held at the offices of the South Yorkshire Joint Secretariat on Friday 20 September 2013 at 10.00 am for the purpose of transacting the business set out in the agenda.**

**M V Oades**
**Deputy Clerk and Monitoring Officer**

This Matter is being dealt with by: Mel McCoole Tel: 01226 772804
Email: mmccoole@syjs.gov.uk Fax: 01226 772899

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## Distribution

Councillors K Goulty (Chair), R Wraith (Vice-Chair), D Baker, E Butler, J Campbell, R Ford, M Lawton, K Richardson, K Rodgers, L Rooney, A Sangar and P Wootton

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**SOUTH YORKSHIRE PENSIONS AUTHORITY**

**SPECIAL MEETING**

**20 SEPTEMBER 2013 AT 10.00 AM AT THE OFFICES OF THE SOUTH YORKSHIRE JOINT SECRETARIAT, 18 REGENT STREET, BARNSLEY**

**Agenda: Reports attached unless stated otherwise**

| | **Item** | **Page** |
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| 1 | Apologies | |
| 2 | Announcements | |
| 3 | Urgent Items<br><br>To determine whether there are any additional items of business which by reason of special circumstances the Chair is of the opinion should be considered at the meeting; the reason(s) for such urgency to be stated. | |
| 4 | Items to be considered in the absence of the public and press<br><br>To identify items where resolutions may be moved to exclude the public and press. (For items marked * the public and press may be excluded from the meeting). | |
| 5 | Declarations of Interest | |
| 6 | Call for Evidence on the Future Structure of the Local Government Pension Scheme | 1 - 64 |

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**SOUTH YORKSHIRE PENSIONS AUTHORITY**

**20 SEPTEMBER 2013**

**Report of Clerk and Treasurer**

# CALL FOR EVIDENCE ON THE FUTURE STRUCTURE OF THE LOCAL GOVERNMENT PENSION SCHEME

## 1) Purpose of the Report

To provide Members with background information regarding the discussion paper and call for evidence published by the Department for Communities and Local Government in June on the future structure of the Local Government Pension Scheme.

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## 2). Recommendation

**Members are asked to consider the paper and the nature of any response to the consultation process.**

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3) Background Information

3.1 Late in June the Government published a series of consultations on prospective changes to the Local Government Pension Scheme. One of these called for evidence regarding costs of administering the LGPS. The "hidden" agenda is clearly a move towards merging LGPS funds. The paper is attached as an appendix.

3.2 CLG is hoping that responses to the call for evidence will be received by 27 September 2013.

3.3 Due to time pressures it has not been possible to prepare a formal report. However, officers will make a presentation at the meeting.

3.4 To facilitate discussion please find attached two papers. The first, produced by the East Riding Pension Fund in conjunction with WM and presented to the Local Authority Pension Fund Forum, is a comprehensive document and could well form the basis of any response. The second paper is an extract from the Local Government Chronicle reporting upon the reaction of Hymans Robertson, one of the leading actuarial consultancies, to the merger debate.

4) Implications

4.1 Financial

If it is decided to merge LGPS funds there will be considerable but unquantifiable financial implications arising out of the costs of amalgamation. Proponents of mergers argue that ongoing costs will be reduced thereafter.

4.2 Legal

There are no known legal implications other than those referred to.

4.3 Diversity

There are no diversity implications.

4.4 Risk

The Authority needs to be in a position to monitor and respond to changes that affect the working of the Authority and be seen to be operating effectively. There is an unquantifiable reputational risk associated with failing to so.

S Pick
Clerk and Treasurer

Officer responsible:
John Hattersley, Fund Director
Tel: 01226 772873

**Background papers** used in the preparation of this report are available for inspection at the offices of the Authority in Barnsley.

**Other sources and references:** None

Appendix A

Department for
Communities and
Local Government

# Call for evidence on the future structure of the Local Government Pension Scheme

**Background**

In 2010, the Government commissioned Lord Hutton to chair the Independent Public Service Pensions Commission. The purpose of the Commission was to review public service pensions and to make recommendations on how they could be made sustainable and affordable in the long term, while being fair to both taxpayers and public sector workers. Lord Hutton's final report was published on 10 March 2011. Among its recommendations, the report made clear that the benefits of co-operative working between local government pension scheme funds and achieving administration efficiencies more generally should investigated further. The Local Government Pension Scheme currently costs local taxpayers £6billion a year in employer contributions.

***Recommendation 23****: Central and local government should closely monitor the benefits associated with the current co-operative projects within the LGPS, with a view to encouraging the extension of this approach, if appropriate, across all local authorities. Government should also examine closely the potential for the unfunded public service schemes to realise greater efficiencies in the administration of pensions by sharing contracts and combining support services, including considering outsourcing.*

Lord Hutton went on to comment about the need for change and improved scheme data. At paragraph 6.1 he said:

*In its interim report, the Commission noted the debate around public service pensions is hampered by a lack of consensus on key facts and figures and a lack of readily available and relevant data. There are also inconsistent standards of governance across schemes. Consequently it is difficult for scheme members, taxpayers and commentators to be confident that schemes are being effectively and efficiently run. It also makes it more difficult to compare between and within schemes and to identify and apply best practice for managing and improving schemes.*

On 16 May 2013, the LGA and DCLG held a roundtable event on the potential for increased co-operation within the Local Government Pension Scheme, including the possibility of structural change to the current 89 funds. 25 attendees represented administering authorities, employers, trade unions, the actuarial profession and academia.

The roundtable aimed to bring objectivity and transparency to the subject through open debate. There was a full discussion of the possible aims of reform and the potential benefits of structural change, together with the further work needed to provide robust evidence to

support emerging options. The meeting focused on the issues to be addressed by reform rather than the detailed arguments for any of the potential ways forward that have been proposed.

The roundtable heard about the projects being undertaken to look at the options for structural reform of the Scheme in London and Wales and considered the range and relative priorities of the desired outcomes of reform, the data requirements for determining a start point and target and the next steps for delivering those outcomes.

On 22 May at the National Association of Pension Funds' local authority conference, the Local Government Minister Brandon Lewis said:

*I am determined that we make progress and make it as quickly as reasonably possible. I can therefore announce this morning, that we will consult later in the year on a number of broad principles for change. This will be your opportunity to tell us what reforms could be made to both help improve your investment performance and reduce your fund management costs.*

*The consultation will not set out some pre-determined solution to what is undoubtedly a complex and contentious issue. I am neither ruling anything in nor ruling anything out at this stage. However, the clear message from me this morning is that I am not wedded to the existing number of 89 funds in England and Wales. If it takes a smaller number of funds to improve the efficiency and cost-effectiveness of the scheme, I shall not shy away from pursuing that goal.*

*I have talked a fair amount about the need for robust data to inform decisions. I am therefore working with the LGA and others to launch a call for evidence, which will both inform our consultation and help all involved formulate their views in response to the consultation.*

*You will be aware that work is well underway to establish a shadow national pensions board for the Scheme. I have met with the LGA and local government trades unions on several occasions to discuss the sort of work that I would like the board to undertake.*

This document sets out the call for evidence from DCLG and the LGA, working with the Shadow Scheme Advisory Board, and explains how it will feed into the forthcoming consultation.

## The call for evidence

At the roundtable, the following high level and secondary objectives for structural reform were proposed:

<u>High level objectives</u>

1. Dealing with deficits
2. Improving investment returns

<u>Secondary objectives</u>

1. To reduce investment fees
2. To improve the flexibility of investment strategies

3. To provide for greater investment in infrastructure
4. To improve the cost effectiveness of administration
5. To provide access to higher quality staffing resources
6. To provide more in-house investment resource

The roundtable also agreed that, although there is a wide range of data available on Local Government Pension Scheme funds, it is currently widely dispersed and would benefit from enhancement, collation and further analysis. It also considered how best to achieve a high level of accountability to local taxpayers, particularly if services are to be shared or funds merged.

In your response to this call for evidence, it would be helpful if you could have particular (although not exclusive) regard to the following questions and provide evidence in the form of annexes to support your answers.

**Question 1 – How can the Local Government Pension Scheme best achieve a high level of accountability to local taxpayers and other interested parties - including through the availability of transparent and comparable data on costs and income - while adapting to become more efficient and to promote stronger investment performance.**

**Question 2 – Are the high level objectives listed above those we should be focussing on and why? If not, what objectives should be the focus of reform and why? How should success against these objectives be measured?**

**Question 3 – What options for reform would best meet the high level objectives and why?**

**Question 4 – To what extent would the options you have proposed under question 3 meet any or all of the secondary objectives? Are there any other secondary objectives that should be included and why?**

**Question 5 – What data is required in order to better assess the current position of the Local Government Pension Scheme, the individual Scheme fund authorities and the options proposed under this call for evidence? How could such data be best produced, collated and analysed?**

## Timetable

Responses to this call for evidence should be submitted in electronic form to Victoria Edwards at: LGPSReform@communities.gsi.gov.uk

The closing date for submissions is 27 September 2013.

The submissions will then be analysed by DCLG and the LGA, working with the Shadow Scheme Advisory Board. You may be asked to provide further clarification and/or evidence to support your answers during that process.

The analysis of submissions will then inform a formal consultation on the options for change to be published by DCLG in the early autumn.

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# ANALYSIS OF THE UK LOCAL GOVERNMENT PENSION SCHEME

## A Critical Analysis of Investment Performance, Costs, and Management Arrangements

JUNE 2013

## EXECUTIVE SUMMARY

Since the publication of the final report from the Independent Public Services Pension Commission ("Hutton Report") there has been an increasing debate within the Local Government Pension Scheme, the Government, and also the pensions and investment industry regarding the appropriate structure of the LGPS in order to ensure that the scheme is affordable and sustainable in the long term. The key areas of this debate have concerned the optimum size of an LGPS fund, the improvement of fund governance, and the potential for cost savings.

The scope of this report is to contribute to this debate by analysing and determining the possible causes of difference in investment performance, investment management costs, and pension administration costs across the LGPS funds.

Section 1 provides a critical analysis of the existing studies that are relevant to the current debate regarding the LGPS. There have been numerous studies in the last few years which have analysed the impact of the size of a pension fund on performance, investment costs and administration costs. Some of these studies have focused on the LGPS, either on a regional or national basis or the LGPS as a whole, whereas other studies have focused on other institutional pension funds on a global basis. The key findings of these various studies were:

- There is no clear evidence that larger funds generate better performance over the long term compared to smaller funds, although there is wider dispersion of performance in smaller funds;

- Larger funds tend to have lower investment management costs, as a percentage of funds under management, but these benefits may not accrue to a combined fund due to potentially considerable transition costs, and there is also evidence that the cost benefits diminish as the size of the fund increases;

- Although there is no clear evidence that larger funds have lower pension administration costs, there are potential savings from a combined fund through the elimination of task duplication but it is not clear that this would be sufficient to compensate for the loss of local presence;

- Internally managed funds tend to generate better performance over the long term, partly due to lower transaction costs as a result of significantly lower portfolio turnover. In addition, these funds tend to have significantly lower investment management costs which enhances the performance differential to externally managed funds. There is also evidence that internally administered funds have lower pension administration costs than externally administered funds; and

- There was no clear evidence that the wholesale merger of funds would result in a significant improvement in performance or result in material cost savings after taking into account the costs of transition. However, there was some support that increased collaboration between funds could capture the majority of these benefits without the need for a potentially expensive and disruptive merger process.

Section 2 analyses the long term performance data of the individual LGPS funds to determine whether drivers such as fund size, management arrangements, or asset allocation have a significant impact on fund performance. The key findings of this analysis are:

- There is no clear correlation between fund size and performance for externally managed funds with a correlation coefficient of just 0.18 for the 10 years to 31 March 2012 and 0.20 for the 20 years to 31 March 2012;
- Internally managed funds have outperformed externally managed funds by 80bps p.a. over the 10 year period and by 50bps p.a. over the 20 year period before the deduction of investment management costs;
- Internally managed funds have lower transaction costs due to significantly lower levels of portfolio turnover, particularly in Equities, and a lower exposure to pooled funds; and
- Asset allocation is not a key determinant of the variation in performance.

Section 3 analyses the investment management cost data of the individual LGPS funds to determine whether size or management arrangements have a significant impact on relative costs. The key findings of this analysis are:

- Larger funds tend to have lower investment management costs; and
- Internally managed funds have significantly lower investment management costs.

Section 4 performs the same analysis for pension administration costs with similar findings in that larger funds tend to have lower administration costs and internally administered funds have significantly lower administration costs.

Sections 2 – 4 also include additional information that would be useful for conducting further analysis.

Section 5 builds on the evidence gathered in the rest of the report which suggests that there is a significant benefit to be derived from internal investment management and administration arrangements. This section concludes that internally managed funds offer an attractive alternative in terms of long term performance and cost efficiency, and that the key issues for internal management are fund size, keyman risk and succession planning, and recruitment and retention of staff, none of which are insurmountable.

The appendices to this report show the performance and cost data for each of the individual LGPS funds and the sources of this data.

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## REVIEW OF EXISTING STUDIES

There have been numerous studies in the last few years which have analysed the impact of the size of a pension fund on fund performance, and investment and administration costs. Some of these studies have focused on the LGPS, either on a regional or national basis or the LGPS as a whole, whereas other studies have focused on other institutional pension funds on a global basis, with a focus on North America. This section provides a summary and critical analysis of these studies.

### "Scottish LGPS Pathfinder Project Phase 1: Options Appraisal", Hymans Robertson, November 2009

The initial report considered three options – separate funds with shared administration; separate funds with shared investment management; and rationalisation of funds.

The report expected the following developments in investment management within the LGPS:

- Widening range of asset classes, investment vehicles, and investment instruments to be analysed and evaluated, with a greater focus on strategy and risk management; and

- The need for an increasing, and ever more knowledgeable, internal resource able to deal with increased investment complexity; a decision making structure with clear delegation to an executive who can take advantage of investment opportunities as they arise; increasing demand for high standards of corporate governance; and continuing pressure to reduce costs.

The findings of the report were:

- There is no statistical evidence, either from an analysis of the 11 Scottish LGPS funds or the wider LGPS, to support the assertion that larger funds enjoy better investment performance than smaller funds. However, there is evidence that smaller funds have more extreme (both good and bad) performance.

- There is clear evidence that larger LGPS funds enjoy lower investment management costs demonstrated by larger mandates attracting lower fee rates. The report estimated that the average fee rate for a £250m fund was 44bps p.a. compared to 24bps p.a. for a £5bn fund. However, the report also highlighted that there is a diminishing rate of improvement as there was only a 3bps p.a. reduction in the fee rate for a £5bn fund compared to a £3bn fund. *The report does not make it clear whether the costs of internally managed funds have been incorporated into this analysis and so size may not be the sole determinant of lower investment management costs.*

- The report suggests that some form of collective investment fund (CIF) using internal management resources, rather than external investment managers and consultants, could have the potential for significant cost savings on investment management and possibly an improvement in fund governance and performance. This would mitigate the

significant keyman risk that is evident in LGPS funds, particularly smaller funds, and would enable the recruitment of sufficient staff with wide ranging knowledge, experience and expertise as well as allowing for appropriate succession planning.

- The CIF could be part of one or more local authorities or a separate pension body could be established. Any local authority which wished to become a "host authority" should be required to abide by a good practice code which specified indicative levels of resource, experience, and commitment. The adherence to such a code should be independently reviewed and adherence should be a condition of continued "host" status.

- The report highlights that the major issue with using internal management resources is the difficulty of fitting into local authority pay scales. *This is not an insurmountable issue and should be pursued further if there are suitable benefits to be achieved from using internal management resources.*

- The report suggests that the level of understanding among elected members is lower than in their large private sector scheme counterparts and expected developments in investment management and administration within the LGPS are likely to place an additional demand on elected members. *This suggests that there is an argument for more robust training and possibly for fewer members on committees, who have significant investment knowledge and experience, and who spend a larger part of their time on training and development.*

- The report highlights that there are likely to be considerable transition costs incurred in changing managers. These were estimated at 60 – 80bp of the value of the assets being transitioned, which would account for 4 – 5 years of the estimated annual cost savings. *This demonstrates that the costs of transition as a result of combining funds could be significant.*

- There is the potential to save administration costs of £3m p.a. (2bps p.a. based on assets under management of £15bn as at 31 March 2009) by outsourcing the administration of the Scottish LGPS funds to the Scottish Public Pensions Agency (SPPA). *However, the report recognises that it is not clear whether the SPPA could provide a level of service for this price that is comparable with the current level of service provided by the local administration teams in Scotland.*

- The report highlights that administration costs for the Scottish LGPS funds are not directly related to the size of the scheme and there is evidence that larger funds invest more per member in certain areas such as communications and technology. *As there isn't a standardised level of service within pension administration it is difficult to make a direct comparison between funds.*

- The overall conclusion regarding pensions administration is that rationalising administration within the existing Scottish LGPS funds does not provide a great deal of

scope for cost saving. The report also suggests that the importance of local presence and the time consuming nature of maintaining relationships with employers creates significant challenges for merging administrative services. However, the report does suggest that there is merit in funds adopting a shared service approach in a number of areas such as web-based development or member communication material, as there is evidence that larger funds tend to produce higher quality communication material.

### "Scottish LGPS Pensions Pathfinder Project Phase II: Interim Report", Deloitte, 21 April 2011

The Phase II interim report considered the findings in Phase I in greater detail. The findings of this report were:

- There is no clear evidence that larger schemes perform better than smaller schemes or that there would be a significant improvement in performance either from changing the current structure in the Scottish LGPS or through more complex investment arrangements. *This reaffirmed the conclusion reached in the Phase I report.*

- The report suggested that a shared central resource could be established to provide cost effective technical advice and assistance to officers and elected members on some of the more complex investment opportunities. *This would mitigate some of the issues surrounding the low level of resourcing in some funds and the significant keyman risk identified in the first report.*

- The report conducted an analysis of potential investment management fee savings obtaining indicative fee quotes from a number of managers across active and passive equity and bond mandates of different sizes. This analysis suggested potential cost savings of 3 – 5bp p.a. for active mandates and 0.5 – 1bp p.a. for passive mandates. One of the reasons for this relatively low level of potential cost savings is that there are a number of current investment mandates that have fees which are lower than would be charged for a current equivalent mandate. Transition costs were estimated at 10 – 20bps of the value of the funds transitioned, which would be equivalent to 4 – 10 years of fee savings. The overall conclusion was that investment management fee savings of £2m p.a. (1bp p.a. based on assets of £21.9bn at 31 March 2010) were not significant in the overall context and insufficient to justify moving from the current structure. *This suggests that investment cost savings are unlikely to be the key determinant for considering the rationalisation of funds.*

- The report did not establish any clear evidence that there are economies of scale to be achieved through the merging of LGPS administration services. The average cost per member is significantly lower in Scotland than in England and Wales with no direct correlation between fund size and administration cost, although this may not be a direct comparison of quality or breadth of service. Administration data for England and Wales shows that there is little variation in costs per member once a fund size of £1bn is reached. The overall conclusion was that there is unlikely to be significant benefits from

centralising pension administration, with costs savings of just £200,000 p.a. (0.1bp p.a.), and that there were considerable transition risks.

- The report highlights that an independent survey of pensions administration costs commissioned by Capita in 2010 covering 400 schemes (including public sector schemes) showed an average cost for third party providers of £41 per member for the largest scheme category (over 10,000 members). *This is considerably higher than the LGPS average (c. £30 per member) shown on page 33.*

- The report also provided the example of Cumbria County Council who considered outsourcing the pension administration function to an external company but concluded that the costs were higher and service levels were lower before opting for a shared service agreement with Lancashire County Council. *This suggests that the outsourcing of pension administration services is likely to result in higher costs and that there are potential efficiencies from an increased focus on LGPS fund collaboration.*

The third stage of the Pathfinder Project appears to have been cancelled with the conclusion that the expected benefits of change were outweighed by the costs.

**"Reconfiguring the London LGPS funds: Evaluation of options", PriceWaterhouse Coopers, October 2012**

The report considered the benefits, in terms of improved investment performance and lower investment management and administration costs, from some form of combination of the 34 London LGPS funds into one fund, either through a collective investment fund (where the asset allocation decision remains with the individual authority) or a framework fund (where there is a full transfer of investment management responsibilities to a central entity).

The findings of the report were:

- There are potential improvements in investment performance of 35bps p.a., equivalent to £84m based on assets under management of £24.2bn (at 31 March 2011). This is based on the assumption that a combined fund would achieve investment returns similar to other larger LGPS funds. *Therefore, in order to substantiate this potential improvement in investment performance, it would be necessary to prove that larger funds generate higher levels of investment performance.*

- There are potential savings of 15bps p.a. in investment management costs, based on a survey of investment managers, equivalent to £36m, as a result of economies of scale. *However, the report suggests that a significant proportion of current investment managers would initially be retained ahead of a process of rationalisation, and so it is unlikely that these economies of scale will accrue in full at first. In addition, the report does not state what size investment mandates needed to be in order to achieve the reported cost savings and has not included the impact of transition costs.*

- There are potential savings of £10m p.a. in administration costs, equivalent to 4bps p.a., due to greater efficiency by reducing the number of administration teams, leading to lower running costs and potentially a better and more consistent service for members and authorities. *The report highlights that the average administration cost per member in London is almost double the average of all LGPS funds. However, this may be a function of the level of outsourcing of the administration function in the London LGPS funds (27% of assets under management) compared to the LGPS ex-London average (6%). There is also no guarantee that there will be an improvement in service.*

- The report states that London LGPS funds have typically not performed as well as larger LGPS funds. An analysis of the performance of the London funds shows that, over the 10 years to 31 March 2011, the weighted average return of London LGPS funds was 4.9% p.a. compared to an average of 5.7% p.a. for the seven largest LGPS funds in the UK. *As the asset allocation of the London LGPS funds is broadly similar to the asset allocation of the larger LGPS funds this is a meaningful comparison of performance. However, the analysis only includes 28 of the 34 London funds, accounting for c. 70% of the assets under management in London, and so the analysis has the potential to be misleading.*

- The performance analysis of the London LGPS funds shows a wide dispersion of relative returns compared to the larger LGPS funds, which, the report suggests, proves that risks can be more effectively minimised by larger funds. *However, this dispersion demonstrates that size cannot be the sole determinant of performance as a number of the smaller London funds have out-performed the average London return over the period under review. Perhaps more significant is that a majority (18 out of 28) of the London funds under review have out-performed the London Pensions Fund Authority (LPFA), the largest London fund by a significant margin. The LPFA generated returns of 3.6% p.a. for the active sub-fund and 6.3% p.a. for the pensioner sub-fund over this 10 year period, a blended return of 4.6% p.a. for the Fund as a whole based on the historic proportion of funds invested in each sub-fund.*

- The report acknowledges that, due to the dispersion of returns and the fact that some smaller London funds have performed well in comparison to the average, any new structure should enable individual funds to make their proven expertise available to all London LGPS funds. *This is a sensible recommendation as it recognises that there is clear evidence that some of the smaller funds have been able to out-perform the average despite their size.*

### "Welsh LGPS: Working Together (Interim Report)", PriceWaterhouse Coopers, March 2013

This report considered the following structures – the current structure of 8 funds; enhanced collaboration including joint procurement and shared services; a number of grouped funds; and one all-Wales LGPS fund. The findings of the report were:

- The report referenced a study by Hymans Robertson that analysed 10 year performance figures for LGPS funds *(the period under review and the proportion of the LGPS covered were not disclosed)* and concluded that there was some evidence of correlation between the size of fund and net of fees performance with larger funds out-performing by 0.6% p.a. with lower levels of relative risk. The report suggested that this was not merely due to size but rather the result of economies of scale that allowed improved governance including more internal management and specialist resources, better diversification, bargaining power on investment management fees, and more responsive governance structures. The report also highlighted that none of the Welsh funds currently employ investment specialists to manage investments in-house. *There appears to be significant dispersion around the line of best fit on the graph shown and no statistical data on the correlation between size and performance and so it is difficult to confirm the analysis in the report. In addition, the graph excludes the three largest funds, with the rationale of not wanting to overly influence the results, but the objective is to determine whether larger funds have better performance, and so they should be included.*

- The report suggested that there are potentially significant benefits from funds working collectively through a common investment approach. Enhanced collaboration through pooling investment resources and using some form of collective investment vehicle, rather than fund merger, would achieve this goal in a less disruptive way. Although there is no guarantee that this would result in better performance, the improved governance through economies of scale and a more specialist internal resource was considered to be a key benefit.

- The report concluded that investment management fees were not the key determinant in fund manager selection and asset allocation decisions with a greater focus on the risk-return characteristics of the investment strategy. However, the report did suggest that there was the potential for savings from larger investment mandates and referenced a study carried out by WM Company, State Street's performance measurement division. This study concluded that large funds (over £5bn) that were externally managed had investment management fees that were 7bps p.a. lower than smaller funds (£1 – 2bn) which would result in cost savings of c. £6m p.a. if applied across the Welsh LGPS. The report also highlighted that larger funds that were internally managed had investment management fees that were 20bps p.a. lower than the LGPS average. *This suggests that cost savings on investment management are relatively low for externally managed funds although there is an argument that a large fund that was internally managed could generate higher savings.*

- The report concluded that there were likely to be significant one-off costs in transitioning the assets of the individual funds to a new organisational structure which could take several years to pay back. The report estimated that transition costs could range from £11 – 46m which equate to 0.5 – 2.1x the annual investment management fees incurred by the Welsh LGPS in 2010 – 11 (£22.3m) and would outweigh any saving in management fees. *The transition costs are relatively significant and, assuming potential annual cost savings of £3 – 7m, would result in a payback period of 3 – 15 years.*

- The report concluded that there was less scope for substantial cost savings in pension administration and that it was more important to retain a local presence for service delivery. The report also highlighted that the absence of common service standards makes it difficult to make a meaningful comparison between funds. *This is a similar conclusion to the one reached in the Scottish Pathfinder Project.*

The overall conclusion of the report was that enhanced collaboration is the preferred option where the balance of service delivery and efficiency, cost of change, time and resources can be blended in the most effective way. The no-change option was not considered appropriate nor was the assessment of a full merger as the majority of gains could be realised through greater collaboration (including managing Fund investment assets on a collective basis) on a timely basis in a less disruptive manner, and would avoid the loss of local autonomy.

**"Lessons from Internally Managed Funds", State Street Investment Analytics (WM Company), March 2013**

WM Company monitor the performance of 21 internally managed pension funds which accounted for £174bn of assets (at 31 December 2011) or 37% of the WM All Funds Universe. Of these internally managed funds, 6 are LGPS funds (West Yorkshire, South Yorkshire (including South Yorkshire Passenger Transport), East Riding, Teesside, and Derbyshire) representing £17bn of assets (15% of LGPS assets monitored by WM).

Internal management is defined as those funds where more than two-thirds of assets are invested by an in-house investment team, either through direct or pooled investments. The internally managed funds identified by WM Company manage an average of 90% of assets in-house (range of 73 – 100%).

The findings of the report are:

- Internally managed funds have consistently outperformed externally managed funds over the long term, as can be seen in the following table:

| | 5 YEARS | 10 YEARS | 20 YEARS | 25 YEARS |
|---|---|---|---|---|
| Internal | 3.7% | 6.2% | 8.6% | 8.9% |
| All Funds | 3.5% | 5.9% | 8.3% | 8.6% |
| Relative | +0.2% | +0.3% | +0.3% | +0.3% |

*Annualised performance to 31 December 2011*

These figures are net of transaction costs (including management fees for pooled investments) but exclude direct investment management costs. When these costs are taken into account the level of outperformance by internally managed funds increases by a further 0.2% p.a.

- Internally managed funds have consistently outperformed externally managed funds across all asset classes, as can be seen from the following table:

| | 5 YEARS | 10 YEARS | 20 YEARS | 25 YEARS |
|---|---|---|---|---|
| **UK Equities** | | | | |
| Internal | 1.4% | 4.9% | 8.4% | 9.1% |
| All Funds | 1.1% | 4.8% | 8.1% | 8.9% |
| Relative | +0.3% | +0.1% | +0.3% | +0.2% |
| **Overseas Equities** | | | | |
| Internal | 2.4% | 5.3% | 7.8% | 7.4% |
| All Funds | 2.4% | 5.0% | 7.6% | 7.0% |
| Relative | +0.0% | +0.3% | +0.2% | +0.4% |
| **Property** | | | | |
| Internal | (1.6%) | 6.7% | 8.1% | 8.5% |
| All Funds | (2.1%) | 6.4% | 8.1% | 8.5% |
| Relative | +0.5% | +0.3% | +0.0% | +0.0% |
| **Alternatives** | | | | |
| Internal | 6.3% | 7.0% | N/A | N/A |
| All Funds | 4.6% | 6.1% | N/A | N/A |
| Relative | +1.7% | +0.9% | N/A | N/A |

*Annualised performance to 31 December 2011*
N/A – data not available

- The level of performance of internally managed funds has been consistent over time with these funds outperforming the WM All Funds Universe in 17 of the 25 years to 31 December 2011, with the majority of internally managed funds exhibiting a lower level of risk than the Universe. In addition, internally managed funds have out-performed in 5 of the 6 years that have seen negative returns during this 25 year period.

- WM highlight some of the characteristics of internally managed funds which may contribute to this consistent level of outperformance. These include:

  - A long term focus which is less concerned with following the latest trends in investment management or chasing quarterly performance targets, and a tendency to invest on a diversified, low-risk basis with a lower targeted level of outperformance than active external mandates;

  - Minimal exposure to passive mandates (2% of assets in 2011) compared to externally managed funds (27%) but a tendency to hold a broader range of stocks with much lower portfolio turnover than traditional active managers;

  - Overseas equities continue to be managed on a global basis despite the industry move away from regional overseas equities to a global "bottom up" basis;

  - Internally managed funds have significantly lower levels of turnover in equity markets (25% p.a. for UK equities and 46% p.a. for Overseas equities) which is approximately half the level of turnover in externally managed funds. This is even more noticeable in the LGPS where internally managed funds have even lower levels of turnover (13% p.a. for UK equities and 20% for Overseas equities) compared to externally managed funds (42% and 64% respectively). This reflects a longer term approach to investment which incurs fewer transaction costs;

  - Investment team and sponsors interests are aligned and independent advisers tend to be collaborative; and

  - Funds do not suffer from the costs of changing investment managers that adversely impact the long term performance of externally managed funds.

- Internally managed funds have significantly lower investment management costs (average of 10bps p.a.) compared to externally managed funds (average of 33bps p.a.) which increases the level of outperformance highlighted on page 11 by a further 0.2% p.a.

- WM highlight that internally managed LGPS funds generally have smaller investment teams (average of 13 with a range of 8 – 22) compared to other internally managed funds (average of 30 with a range of 7 – 51).

- WM consider the three main issues for internally managed LGPS funds are keyman risk and succession planning given the small size of internal investment teams, and incorporating a fund management operation into a local authority pay scale given the specialist nature of the investment function. WM use the Canadian public sector pension funds as an example where there has been a move towards an increased level of internal management resulting in an improvement in performance. One of the key factors has been the ability to attract and retain top investment professionals by setting up quasi-independent entities that allow the decoupling of salaries from existing public sector pay scales. If internal management is to be considered a viable option for a wider group of funds or assets in future, the compensation issue will need to be addressed.

**"Capital Stewardship Programme Briefing Paper", UNISON, January 2010**

UNISON analysed data[1] from LGPS fund annual reports and published material by the Department for Communities and Local Government, the Scottish Executive, and the Welsh Assembly. The findings of the report were:

- The LGPS as a whole does not appear to have outperformed passive fund management over the 14 years to 31 March 2009. *However, the analysis compares fund performance (which consists of allocations to a number of asset classes including Equities, Fixed Income, Property, Cash, and Alternatives) to the returns from the FTSE 100 which is inconsistent analysis and a meaningless comparison.*

- The report suggests that the LGPS is focused on "speculative short term buying and selling of stock" and that "larger LGPS funds are in part penalising smaller LGPS funds that have less aggressive or less responsive speculative market trading". *Unfortunately, although the report does raise the issue of whether high levels of portfolio turnover have a negative impact on Fund performance, it does not provide any evidence, such as portfolio turnover data, which backs up a rather spurious claim of speculative investment.*

- Smaller LGPS funds typically have higher administration costs on a per capita basis and higher investment management costs in relation to the level of assets. *This is correct, to a certain extent, but, according to the graph in the report, there appear to be a significant number of smaller funds with relatively low cost ratios.*

[1] There are serious doubts with regard to the methodology used for performance calculation. It is difficult to determine how performance has been calculated as the data for each fund has not been disclosed but there are material differences between the figures provided for two funds mentioned in the report (Hillingdon and Shropshire). According to the report the return for these two funds for the year ended 31 March 2009 were +8.0% and -4.8% respectively whereas the annual report and accounts for these funds show a return of -24.3% and -21.7% respectively. It would appear that the analysis ignores the change in market value of investments during the period which is a fundamental input for performance calculation. Therefore, given the incorrect interpretation of how performance information should be calculated any conclusions reached from analysing this data is null and void.

**"Performance Analysis of LGPS funds", All Pension Group (APG), 2010**

UNISON commissioned APG, the fund management arm of ABP, the Dutch public sector pension fund, to evaluate the investment performance of the LGPS over the period 2001 – 09. The findings of the report were:

- Larger funds consistently achieved higher investment returns[1] over the period 2001 – 09 with the four largest funds outperforming the "generic benchmark" by 2.2% p.a. on average (range of 1.2 – 2.8% p.a.) *However, the LGPS as a whole out-performed the*

*benchmark by 1.0% p.a. and so the relative outperformance of the larger funds is much smaller than the headline figure suggests.*

- Rather than compare the performance of the larger funds to the average LGPS return, the report chooses to use a generic benchmark which is weighted for each funds' different asset allocation and then compared to their actual performance in an attempt to control for different asset allocations. *However, this ignores the fact that some out-performance derives from different weightings to each asset class and so this would appear to only be analysing stock selection performance of individual funds (this was also found to be the case in the Dyck and Pomorski analysis discussed on pages 16 – 18). It would be more appropriate to compare the actual performance of each individual Fund to determine the impact of size.*

- The report highlights that although there is a wider variety of outperformance among smaller funds, the larger funds consistently outperformed the benchmark. *However, there are only 4 funds in the "large" pension fund data set and 80+ funds in the "small" (<£2bn) pension fund data set and so it may not be a fair comparison. For example, 8 of the "small" funds have performed at least in line with the 3 best performing "large" funds and a further 30+ have performed at least in line with the worst performing "large" fund. This suggests that size is not the key determinant to performance.*

- The report suggested that investment management expenses decrease by 0.3% p.a. and administration costs by 0.15% p.a. when the size of a fund increases from £1bn to £8bn. *As with the analysis of fund performance, the report fails to suggest reasons, other than size, for the reduction in investment management and administration costs.*

[1] The performance data was sourced from the "Pension Fund Performance Guide – Local Authority Edition 2010". The use of this data appears to ignore the investment of cash flows during the period which, according to the Global Investment Performance Standards (GIPS®), should be accounted for on a time-weighted basis. This omission would result in a lower calculated return when investment markets are positive and vice versa for falling markets. As the overall return for the LGPS was positive over this period the analysis is likely to have under-estimated LGPS fund performance over this timeframe. It is unclear whether this will have affected the relative analysis of individual funds but the reader should be aware of the potential inconsistencies in the performance data.

### "Internal management does better after costs", CEM Benchmarking Inc., October 2010

The report analysed the performance data of a large number of global defined benefit funds over the period 1991 – 2009. In 2009 there were 363 funds with assets under management of $5 trillion. *However, the average length of time that a pension fund was included in the dataset is 6 years which suggests that the analysis may not be consistent over time.*

The findings of the report were:

- There was no statistically significant difference in gross value added performance between internally and externally managed funds at the asset class level, with relative

performance for internally managed funds ranging from -32 to +57 bps p.a. across Equities and Fixed Income. *However, the report did not analyse the overall performance of each fund to determine whether there is a performance difference at the aggregate level.*

- Once costs are deducted, funds with a greater proportion of internal management outperform due to the lower costs of internal management, with relative performance of 0 to +96bps p.a. across Equities and Fixed Income. As a result, the report suggested that plan sponsors should consider increasing internal management, particularly for asset classes with high relative external management costs.

- The report also considered whether smaller (assets of $5 – 20bn) internally managed funds generated the same level of outperformance and concluded that the level of outperformance was greater (an additional 20 – 30bps p.a. before and after costs) than larger (>$20bn) internally managed funds. *This suggests that there are potential diseconomies of scale for very large funds.*

"Is Bigger Better? Size and Performance in Pension Plan Management", Dyck and Pomorski, July 2011

This report performed a more detailed analysis of the CEM Benchmarking data from 1991 – 2009 which is referenced above and so the same potential deficiencies in the data are also relevant with this report. The findings of the report were:

- The largest funds outperform smaller funds by 43 – 50 bps p.a., with 33 – 50% of this difference arising from cost savings related to internal management. *This cost differential is supported by the WM analysis of internally managed funds in the UK.* The remaining outperformance (50 – 66%) results from an increased allocation to alternative investments and realising greater returns in this asset class through superior monitoring and screening of managers, and the ability to take advantage of co-investment opportunities.

- The higher performance of 43 – 50 bps p.a. is based on "net abnormal returns" which is defined as gross returns minus actual costs minus plan-specific benchmarks which effectively adjusts for different asset allocations across funds. *However, it is questionable whether this is appropriate because it is effectively measuring stock selection performance and ignoring the performance generated from asset allocation. Although the risk profiles of funds should be taken into account when making performance comparisons this is not the most appropriate method with which to measure risk and standard deviation of returns would have been more informative. Therefore, the actual returns of the funds analysed in the study are shown in the table below:*

| | Mean[1] | Large[2] | Small[3] | Large – Small |
|---|---|---|---|---|
| Fund Performance | | | | |
| Gross | 9.23% | 9.42% | 9.27% | 15bps |
| Net | 8.86% | 9.17% | 8.84% | 33bps |

[1] Simple average of quintile data
[2] Top quintile of funds by size
[3] Bottom quintile of funds by size

This table demonstrates that the actual net performance differential between the largest and smallest funds is 33bps p.a., with 15bps p.a. generated through better performance and 18bps p.a. through lower costs.

- Although there is an improvement in performance as funds get larger the smallest funds (quintile 5 – mean assets under management of $0.3bn) have gross performance that is on a par with funds in quintile 3 (mean AUM of $2.1bn) and only 15bps p.a. lower than the largest funds (mean AUM of $33.1bn). It is only when comparing funds from quintile 4 (mean AUM of $0.9bn) where there is a more meaningful difference in performance with the largest funds (+78bps p.a.) *Therefore, it is not clear that size is the key determinant of performance and the data is only supportive of the authors' conclusions when considering the concept of "net abnormal return" but, as discussed above, it is questionable whether this is the appropriate way to adjust for risk.*

- The report highlights that a large number of studies suggest that diseconomies of scale become evident when investment managers within asset classes reach a certain size. The authors contend that large funds would be able to avoid these diseconomies of scale in individual asset classes by altering their asset allocation at the appropriate time. *However, this assumes that funds would be able to determine when this point was reached, and be able to react accordingly, which is a significant assumption to make.*

- Larger plans tend to allocate more to Alternatives, which are associated with higher risk and lower liquidity, and different risk appetites or liquidity requirements may correlate with fund size. The report cautions that better performance in alternative assets for larger funds could be simply due to timing arising from both the vintage effect and the j-curve effect. If larger funds have invested earlier than smaller funds the better performance could just be the effect of the timing of the investments. *The authors suggest that, within real estate, larger funds have also generated better returns and that the j-curve effect will be less likely. However, this ignores the significant upfront fees that are incurred in property investment, including stamp duty (where relevant) and professional fees.*

- Larger funds tend to have lower cost ratios than smaller funds in both investment management (18 bps p.a.) and pension administration (9bps p.a.). The report suggests that this is more to do with the level of internal management in larger funds compared to

smaller funds, as the relatively fixed costs of internal management are spread over a larger asset base. As can be seen from the table below, external active managers are significantly more expensive than internal managers for all asset classes. *This suggests that there is a greater benefit from having internal management in larger funds, as the cost differential between internal and external active management is greater for larger funds.*

| | Mean[1] | Large[2] | Small[3] | Large – Small |
|---|---|---|---|---|
| **Fund Expenses** | | | | |
| Investment | 37bps | 25bps | 43bps | 18bps |
| *Equities* | *29bps* | *16bps* | *37bps* | *21bps* |
| *Fixed Income* | *16bps* | *9bps* | *20bps* | *11bps* |
| *Alternatives* | *115bps* | *115bps* | *93bps* | *(22bps)* |
| Administration | 7bps | 3bps | 12bps | 9bps |
| Cost ratio[4] | | | | |
| *Equities* | *3.1* | *3.2* | *2.8* | *0.4* |
| *Fixed Income* | *3.2* | *5.1* | *1.7* | *3.4* |
| *Alternatives* | *5.0* | *6.9* | *3.0* | *3.9* |

[1] Simple average of quintile data
[2] Top quintile of funds by size
[3] Bottom quintile of funds by size
[4] Ratio of costs of external active management to costs of internal active management

- The report highlights that as funds get larger they tend to increase the level of internal management and also move more towards passive investments, particularly in Equities and Fixed Income. However, the report concludes that the use of internal management, rather than passive management, is the more important driver of overall performance. The report also states that, in order to take advantage of savings from increased internal management, funds need the ability to attract and retain appropriately skilled and experienced staff, to provide the right incentives, and to ensure effective oversight structures that are focused on risk and performance rather than political and other factors.

## LGPS INVESTMENT PERFORMANCE

The studies reviewed in the first section failed to establish a clear correlation between the size of funds and investment performance.

This section of the report sought to determine whether larger funds out-perform smaller funds and to identify the causes of any outperformance by analysing the performance of the LGPS funds over the 10 and 20 year periods to 31 March 2012.

There are 101 separate LGPS funds in the UK but the report has excluded the data from the Environment Agency – Closed Fund due to its status as a closed fund.

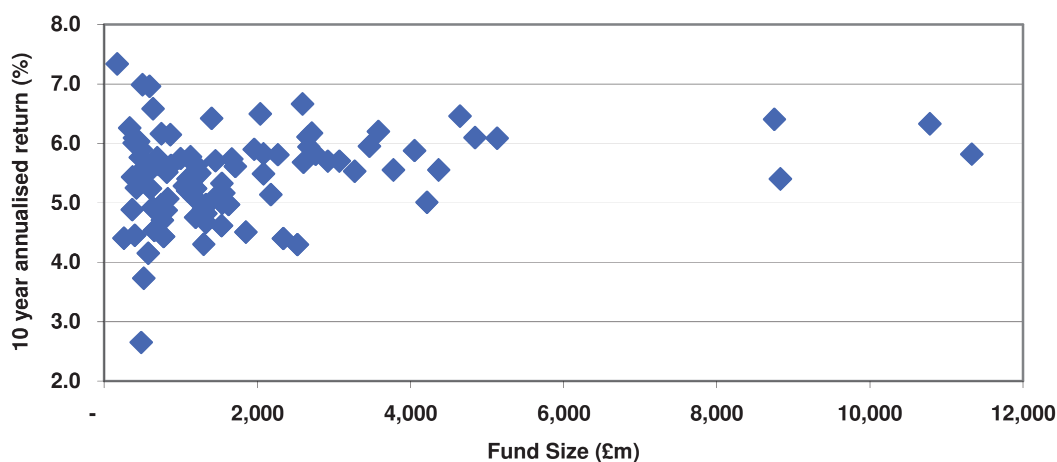
### 10 years ended 31 March 2012

The performance data was collated from the CIPFA "Local Authority Pension Fund Investment Statistics 2002 – 2012". For those funds whose statistics did not appear in the CIPFA publication, performance data was sourced from the individual annual report and accounts or confirmed with the administering authority.

This resulted in performance data for 92 funds, which accounted for £177bn (95%) of LGPS assets under management as at 31 March 2012. The performance data for each fund is shown in Appendix 1.

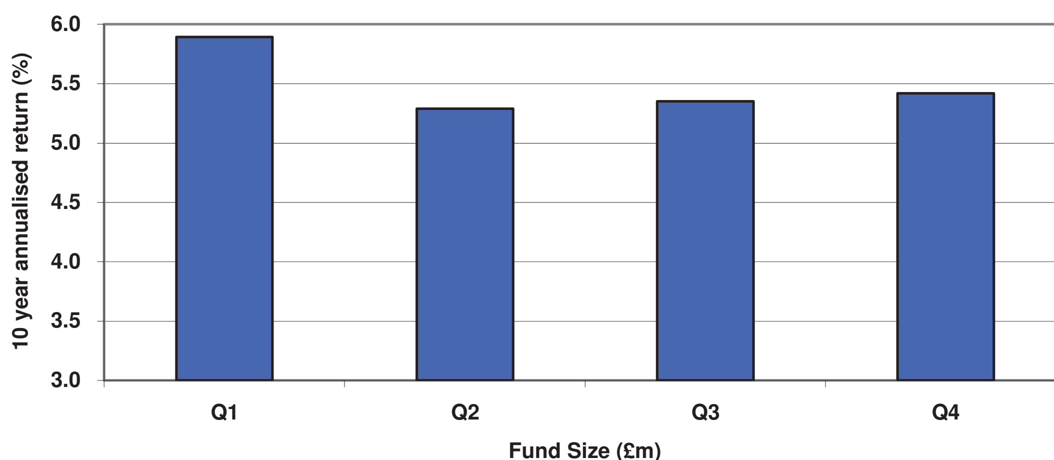
The average fund return over the 10 year period under analysis was 5.7% p.a. (range of 2.7% to 7.3%). The performance figures are shown net of transaction costs and investment management fees for pooled investments. They do not reflect direct investment costs such as management fees for investment mandates (unless these are reflected in unit prices) or internal resource costs, both of which will be considered in the next section.

The individual performance of the 92 funds for which data was available is shown on the following graph:



As can be seen from the graph there is no clear evidence that size is the key determinant of fund performance. This is supported by a correlation coefficient ($r^2$) of just 0.24 between fund size and fund performance over the 10 year period to 31 March 2012.

The following graph shows the performance of the LGPS divided into quartiles based on fund size:



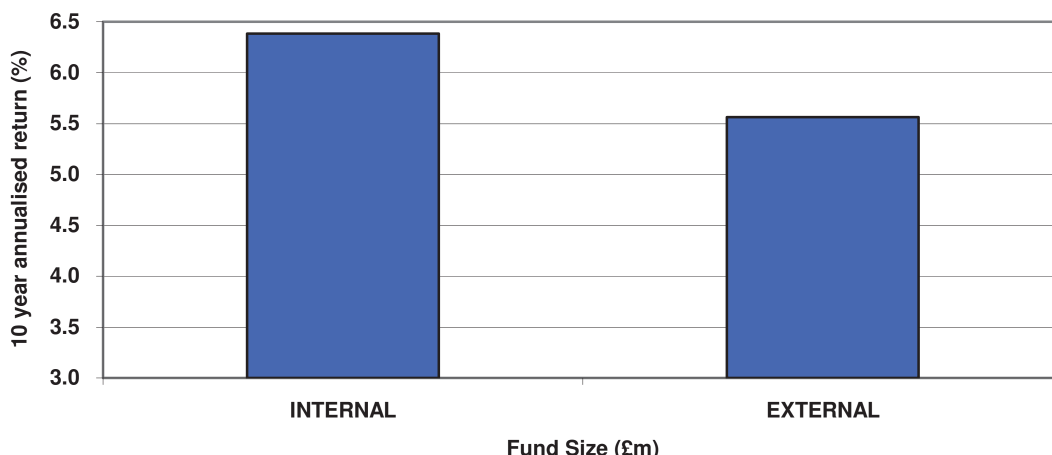

This graph shows that larger funds (Q1, assets under management at 31 March 2012 of £2.5bn+) have outperformed smaller funds by 50 – 60bps p.a. over the 10 years to 31 March 2012. However, as with the first graph, there is no clear correlation between fund size and performance. This is evidenced by the smallest funds (Q4, £0.2 – 0.6bn) outperforming medium sized funds (Q2, £1.3 – 2.4bn) by 13bps p.a. over the same period.

## Management arrangements

This analysis of performance does not take into account the management arrangements within the different LGPS funds.

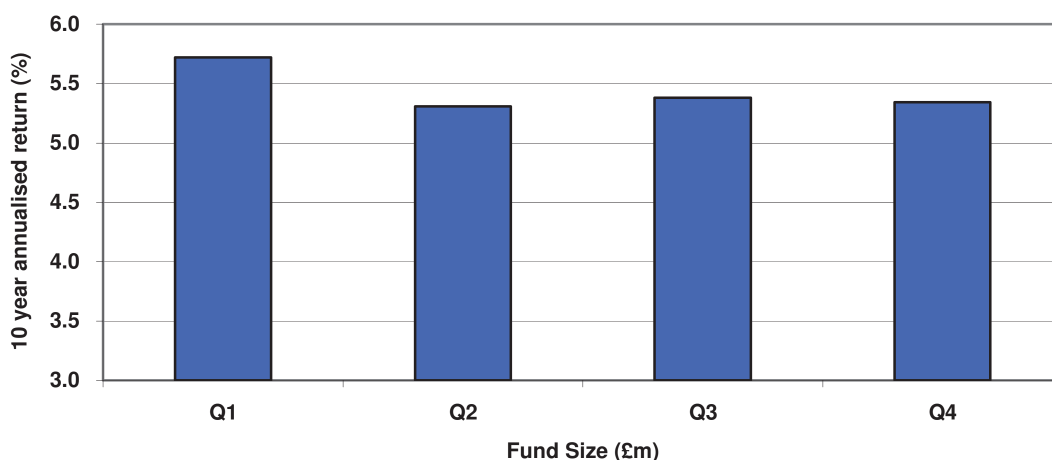
Internally managed funds are defined as those funds that have managed a large proportion (>70%) of assets using an internal investment management team over the entire period under review. Other LGPS funds have managed a smaller proportion of assets in-house, predominantly within Property and Alternatives, and a number of funds have significantly increased the proportion of assets that are managed in-house in recent years.

For the purposes of this report, it is the 5 LGPS funds identified by WM Company on page 11 (West Yorkshire, South Yorkshire, Derbyshire, East Riding of Yorkshire, and Teesside), which accounted for £21.4bn of assets under management (12.1% of the LGPS total) as at 31 March 2012, that have been classified as internally managed funds. The following graph compares the performance of these internally managed LGPS funds with externally managed LGPS funds.




This graph shows that internally managed funds have outperformed externally managed funds by 80bps p.a. over the 10 years to 31 March 2012 which suggests that management arrangements may be a more important determinant of performance than fund size.

This is also supported by the following graph which shows the performance of externally managed funds only divided into quartiles based on fund size.



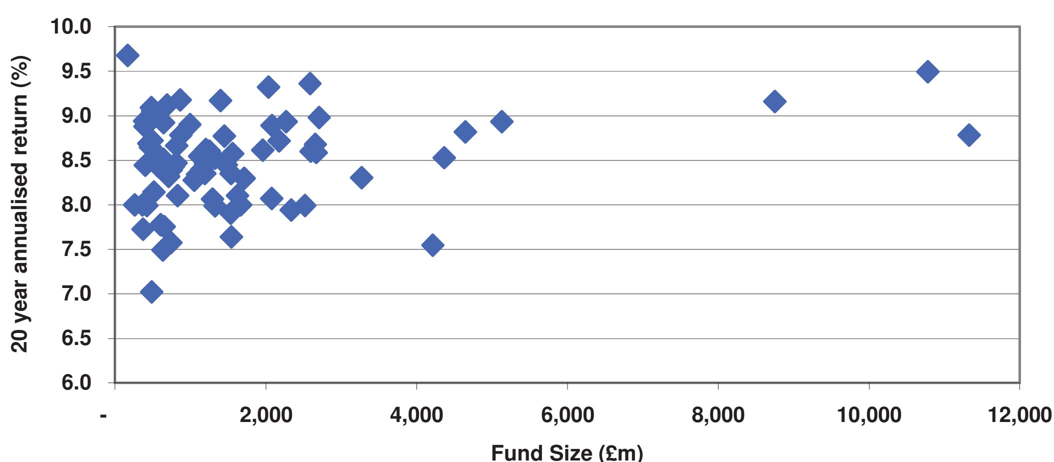

This graph shows that larger externally managed funds have outperformed smaller funds but the performance differential is lower at 30 – 40bps p.a., and the correlation coefficient ($r^2$) between fund size and fund performance falls to just 0.18, suggesting only a weak correlation at best.

### 20 years ended 31 March 2012

A similar analysis has been performed for the 20 year period ending 31 March 2012 by compounding the 10 year annualised returns from the CIPFA "Local Authority Pension Fund Investment Statistics 1992 – 2002" to the returns for the 10 year period ending 31 March 2012 analysed above.

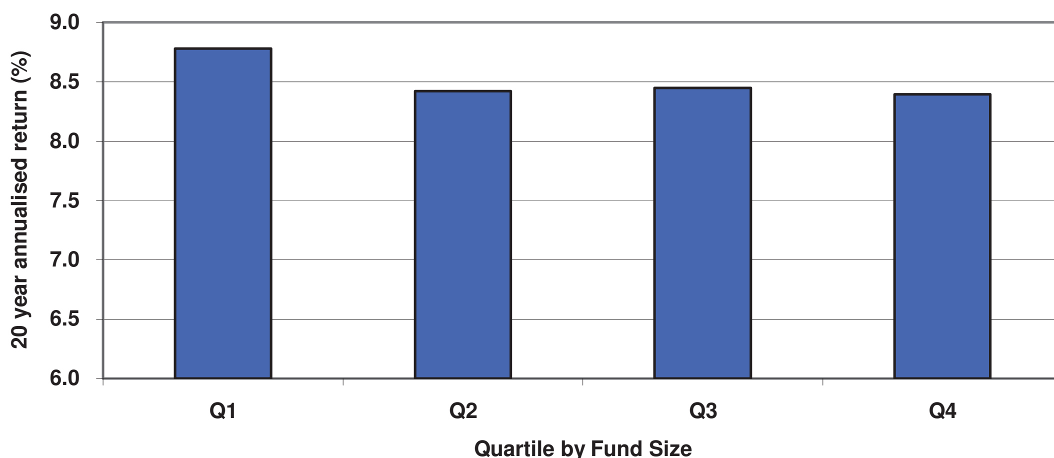
This resulted in performance data for 75 funds, which accounted for £131bn (70%) of LGPS assets under management as at 31 March 2012. The performance data for each fund is shown in Appendix 2. The level of coverage of the LGPS for the 20 year data is lower than for the 10 year data and so the reader should be aware that the analysis may not be directly comparable.

The average fund return over the 20 year period under analysis was 8.6% p.a. (range of 7.0% to 9.7%). As with the 10 year analysis, the performance figures are shown net of transaction costs and investment management fees for pooled investments but do not reflect direct investment costs such as management fees for investment mandates (unless these are reflected in unit prices) or internal resource costs. The individual performance of the 75 funds for which data was available is shown on the following graph:




As with the analysis of the 10 year data, there is no clear evidence that size is the key determinant of fund performance. This is supported by a correlation coefficient ($r^2$) of just 0.27 between fund size and fund performance over the 20 year period to 31 March 2012.

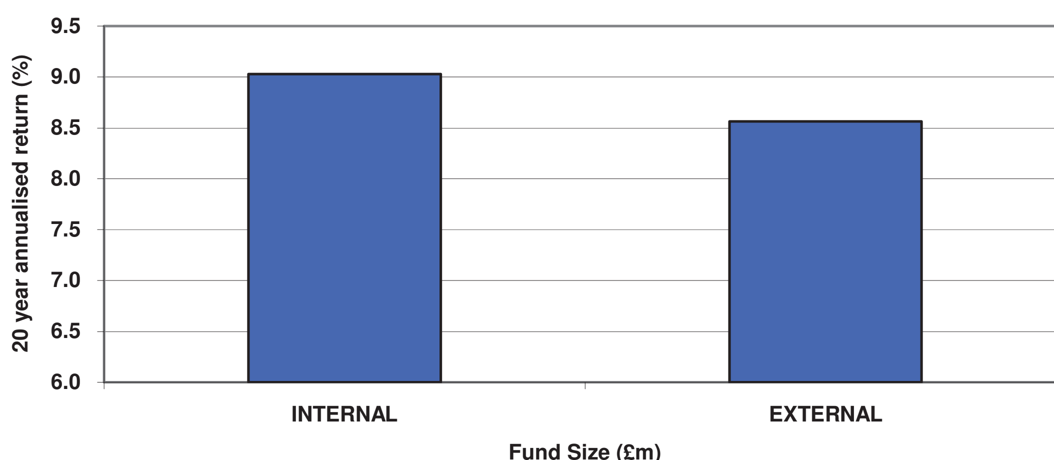
The following graph shows the performance of the LGPS divided into quartiles based on fund size:



This graph also confirms the 10 year analysis in that larger funds (Q1) have outperformed smaller funds, albeit by a smaller magnitude (30 – 40bps p.a.), over the 20 years to 31 March 2012. Unlike the 10 year analysis there is no real variation in performance in the other quartiles over this longer timescale.

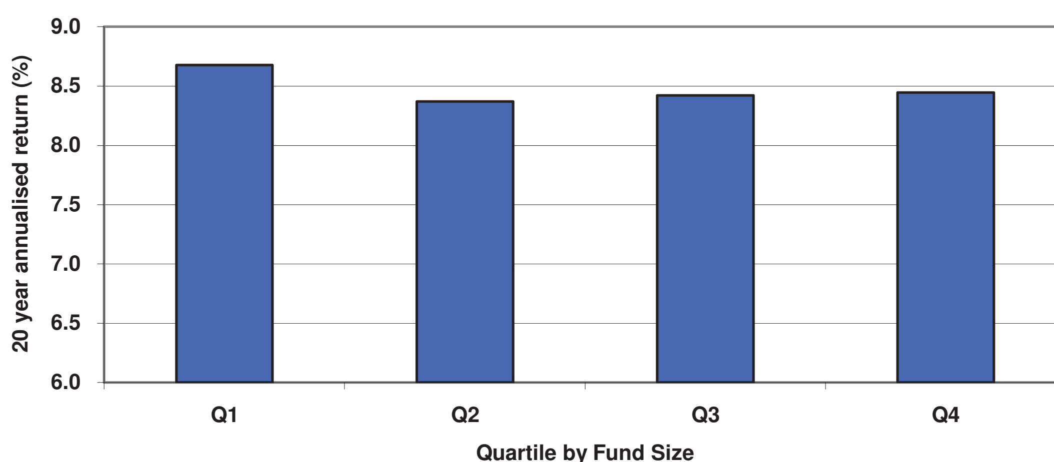
## Management arrangements

The following graph compares the performance of internally managed LGPS funds with externally managed LGPS funds over the 20 year period.




This graph shows that internally managed funds have outperformed externally managed funds by 50bps p.a. over the 20 years to 31 March 2012 which again supports the assertion that management arrangements may be a more important determinant of performance than fund size.

This is also supported by the following graph which shows the performance of externally managed funds only divided into quartiles based on fund size.




This graph shows that larger externally managed funds have outperformed smaller funds but the performance differential is lower at 20 – 30bps p.a., and the correlation coefficient ($r^2$) between

fund size and fund performance falls to just 0.20, again suggesting only a weak correlation at best.

KEY FINDINGS

- There is no clear correlation between fund size and performance for externally managed funds.
- Internally managed funds have outperformed externally managed funds by 80bps p.a. over 10 years and by 50bps p.a. over 20 years, before the deduction of direct investment management costs.

Additional information that would assist in a more detailed analysis:

- Split between internal and external investment management in each LGPS fund to determine whether the correlation between internal management and performance holds for funds with a lower level of internal management.

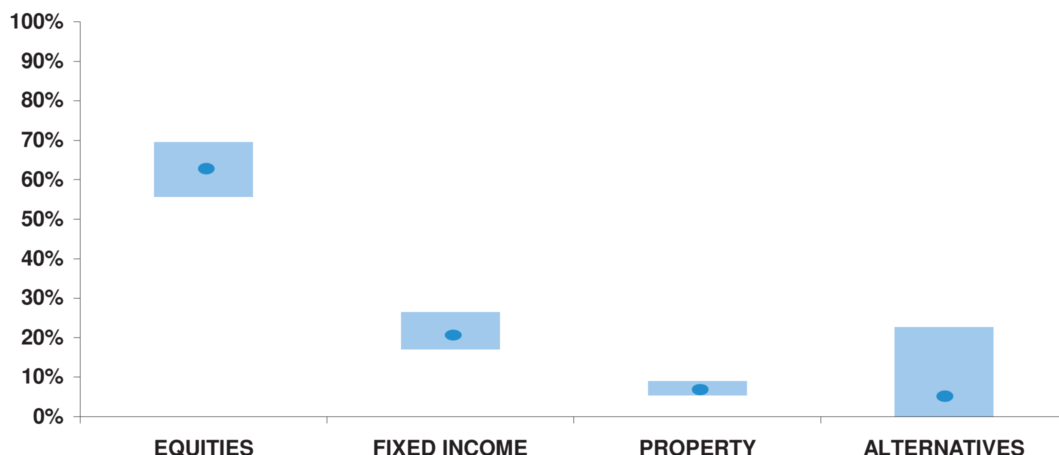
**Asset Allocation**

The published data that is currently available only permits a comparison of absolute performance over the long term and doesn't reflect the relative risk that funds have assumed in order to generate these returns. Therefore, certain funds may have outperformed simply because they have adopted a higher risk profile.

An analysis of the standard deviation of returns for funds would highlight whether funds that have generated higher returns have done so due to a higher risk profile. This data is not available at present but a broad comparison of asset allocation should highlight whether fund performance has been overly influenced by risk appetite.

The following graph shows the weighted average asset allocation of the LGPS in the four main asset classes – Equities, Fixed Income (including Cash), Property, and Alternatives – as at 31 March 2012. It also shows the inter-quartile range, in order to exclude outliers which may unduly skew the analysis. As the analysis of asset allocation is based on a fixed point in time it will not take into account changes to asset allocation over time.

The data is sourced from the CIPFA "Local Authority Pension Fund Investment Statistics 2002 – 2012" or the individual annual report and accounts for those funds not included in the CIPFA publication.




Correlation coefficient between asset allocation and performance

| 0.18 | -0.09 | -0.26 | -0.18 |
|---|---|---|---|

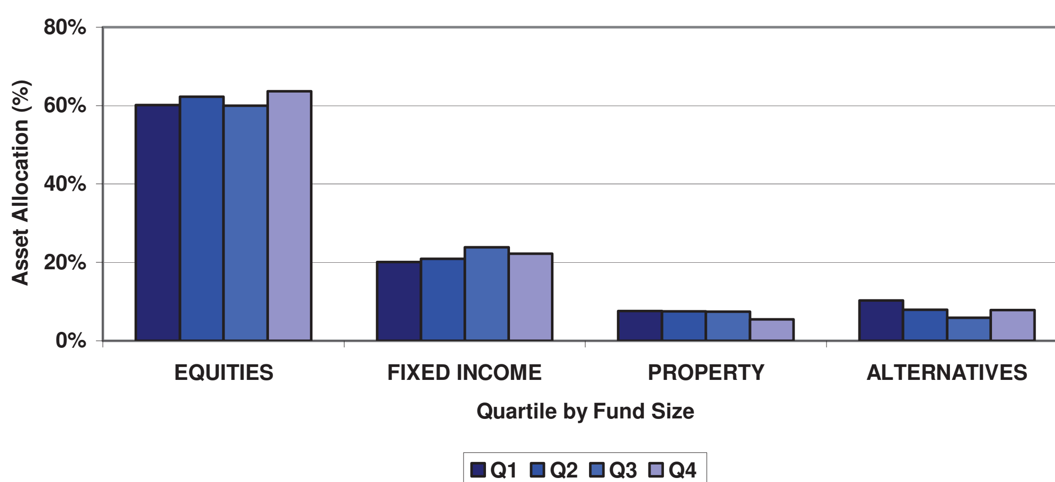
This analysis shows that, in general, LGPS funds have broadly similar asset allocations and, therefore, the analysis of performance data does not appear to be materially affected by different risk appetites.

Although the inter-quartile range has been used for the above graph for presentational purposes, the data for all funds has been used to calculate the correlation between performance and asset allocation.

There is a small positive correlation between the allocation to Equities and performance and a small negative correlation between the allocation to Fixed Income and performance. These relationships would be expected as funds with a higher allocation to Equities would expect to outperform over the long term given the additional risk that is being assumed. However, these relationships are not significant which again confirms that the performance data is not being materially affected by different asset allocations.

There are mildly stronger negative correlations between the allocation to both Property and Alternatives and performance but they are still not significant. These correlations could be due to the significant up-front costs (stamp duty and professional fees in Property and the j-curve effect in Alternatives) in these asset classes and also the tendency for performance data to be lagged compared to Equities and Fixed Income. This could mean that funds that have recently increased their allocation to these asset classes may exhibit weaker performance in the short term.

The following graph shows the asset allocation of funds divided into quartiles based on fund size:




This graph shows that although larger funds tend to have a slightly smaller exposure to Equities and Fixed Income with a higher exposure to Alternatives, there is not a material difference in the asset allocations of different sized funds. Therefore, it can be concluded that variations in asset allocation are not a key determinant of the difference in performance between large and small funds.

KEY FINDING

- Asset allocation is not a key determinant of variation in performance.

Additional information that would assist in a more detailed analysis:

- Quarterly portfolio information for each LGPS fund over the period under review in order to calculate a standard deviation of returns. This will permit the calculation of risk-adjusted returns and determine whether there is a correlation between risk and performance.

- Average asset allocation for each LGPS fund over the full period under review to determine the impact on performance.

### Transaction costs

The performance analysis above is based on performance figures which are net of transaction costs and investment management fees for pooled investments. Data on transaction costs and pooled investment management fees is not readily available for the LGPS and, therefore, it is not possible to determine whether the funds that have experienced better performance also have lower transaction costs.

In their analysis of pension funds on pages 11 – 13, WM Company provided data on equity portfolio turnover and suggested that one of the reasons that internally managed funds have outperformed could be due to lower transaction costs as a result of lower portfolio turnover.

WM calculated that internally managed LGPS funds had significantly lower turnover in Equities than externally managed funds, as can be seen from the following table:

| | UK Equities | Overseas Equities |
|---|---|---|
| Internally managed | 13% | 20% |
| Externally managed | 42% | 64% |
| Ratio | 0.31 | 0.31 |

This means that, other things being equal, externally managed funds would have incurred transaction costs that are more than three times higher than internally managed funds in Equities. The typical transaction costs for Equities are as follows:

| | UK Equities | Overseas Equities |
|---|---|---|
| Commission | 15 – 20bps | 15 – 20bps |
| Transaction tax | 50bps | 0 – 20bps |
| Bid-ask spread | 5 – 20bps[1] | 5 – 30bps[2] |
| Total cost[3] | **90 – 130bps** | **40 – 120bps** |

[1] Based on average bid-ask spreads for FTSE 100 and FTSE 250 stocks in May 2013
[2] Based on average bid-ask spreads for large and mid-cap US and European stocks in May 2013
[3] Assumes a purchase and a sale, incurring the transaction cost on the purchase only and commission and bid-ask spread on both the purchase and the sale

The following table summarises the potential difference in annual transaction costs between internally managed and externally managed LGPS funds, based on historic portfolio turnover and estimated transaction costs.

| | UK Equities | Overseas Equities |
|---|---|---|
| Internally managed | 12 – 17bps | 8 – 24bps |
| Externally managed | 38 – 55bps | 26 – 77bps |
| Difference | **26 – 38bps** | **18 – 53bps** |

The performance analysis on pages 20 – 24 demonstrated that internally managed LGPS funds have outperformed externally managed funds by 80bps p.a. over the last 10 years and 50bps p.a. over the last 20 years. The analysis of transaction costs suggests that, when applying the average LGPS fund allocation to Equities of c. 65%, c. 20 – 25bps p.a. of the outperformance is due to smaller transaction costs as a result of lower levels of portfolio turnover in Equities.

There may also be an additional impact from lower levels of portfolio turnover in the other major asset classes, particularly as transaction costs are likely to be higher than Equities in both Property and Alternatives. However, as there is no published data showing LGPS fund turnover levels in these asset classes it is difficult to accurately measure this impact.

Internally managed funds would also be expected to have a lower level of exposure to pooled investments by virtue of a greater level of direct investments. There is a wide variation of investment management costs in pooled investments within Equities but they tend to average c. 50 – 100bps for active funds. However, as there is no published data showing LGPS fund investments split between direct and pooled investments it is also difficult to accurately measure this impact.

KEY FINDING

- Internally managed funds have lower transaction costs compared to externally managed funds due to:
    - Significantly lower levels of portfolio turnover, particularly in Equities; and
    - Lower level of exposure to pooled funds.

Additional information that would assist in a more detailed analysis:

- Portfolio turnover for each major asset class to determine whether funds with lower turnover tend to have better performance.
- Annual costs of pooled funds to determine the impact of external management costs on performance.

## LGPS INVESTMENT MANAGEMENT COSTS

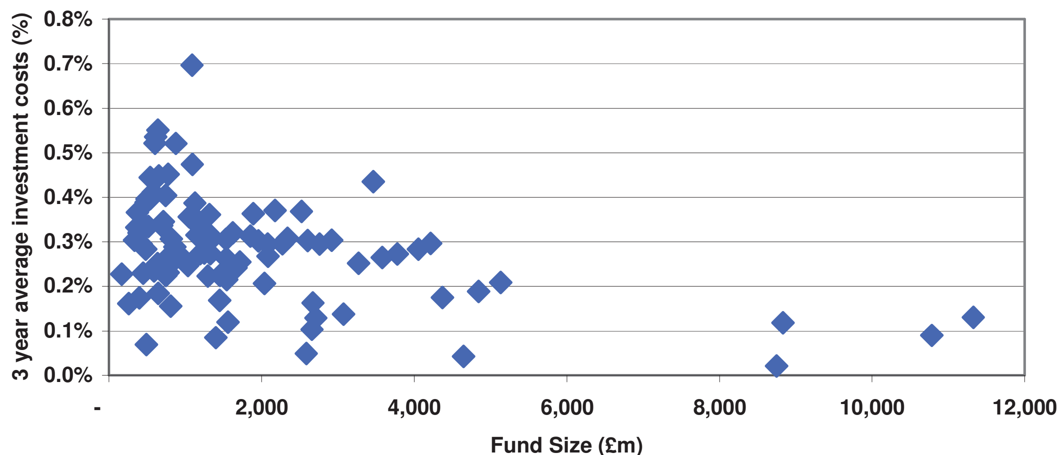
The majority of the studies reviewed in the first section concluded that larger funds tended to have lower investment management costs as a percentage of assets under management.

This section of the report sought to determine whether larger funds have lower investment costs, as a percentage of assets under management, than smaller funds and to identify the causes of any differences by analysing the average investment management costs of the LGPS funds over the three years to 31 March 2012.

The cost data was collated from the individual annual report and accounts of each LGPS fund and divided by the assets under management at the end of each financial year to provide a 3 year average figure for investment costs. This resulted in cost data for all 100 funds under review with the data for each fund shown in Appendix 3.

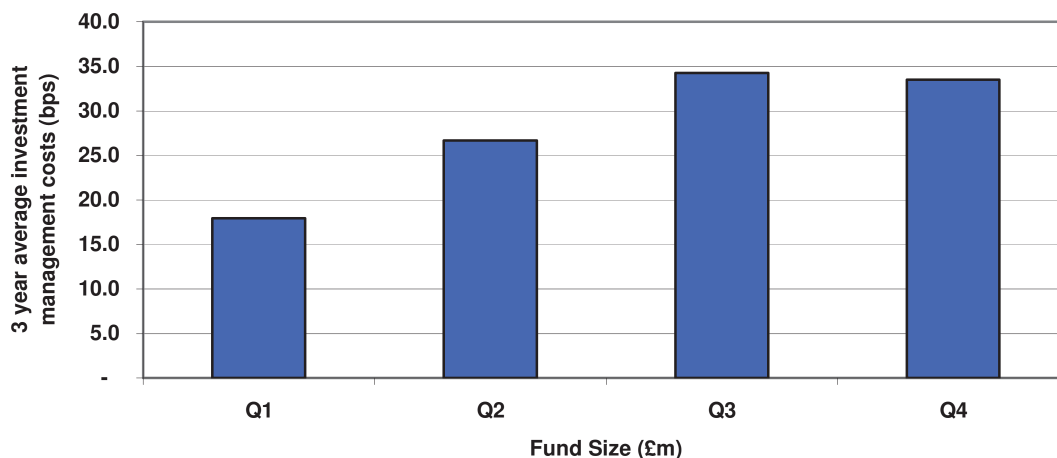
The average annual cost of investment management over the 3 year period under analysis was 23bps p.a. (range of 2bps to 70bps). The cost figures include management fees for investment mandates and internal investment resource costs but exclude transaction costs and management fees on pooled investments.

The individual costs of the 100 LGPS funds are shown on the following graph:




As can be seen from the graph, it does appear that there is some correlation between fund size and investment management costs with larger funds enjoying lower management costs as a percentage of assets. This is supported by a correlation coefficient ($r^2$) of -0.44 for the 3 year period to 31 March 2012.

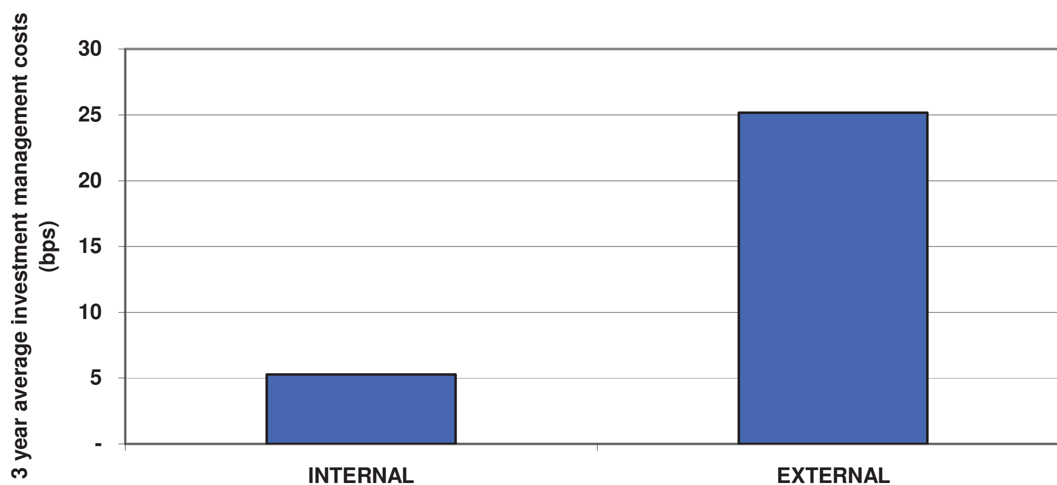
The following graph shows the investment management costs of the LGPS divided into quartiles based on fund size:




This graph shows that larger funds have investment cost ratios that are, on average, 10 – 15bps lower than smaller funds, although there is a wide variation within each quartile.

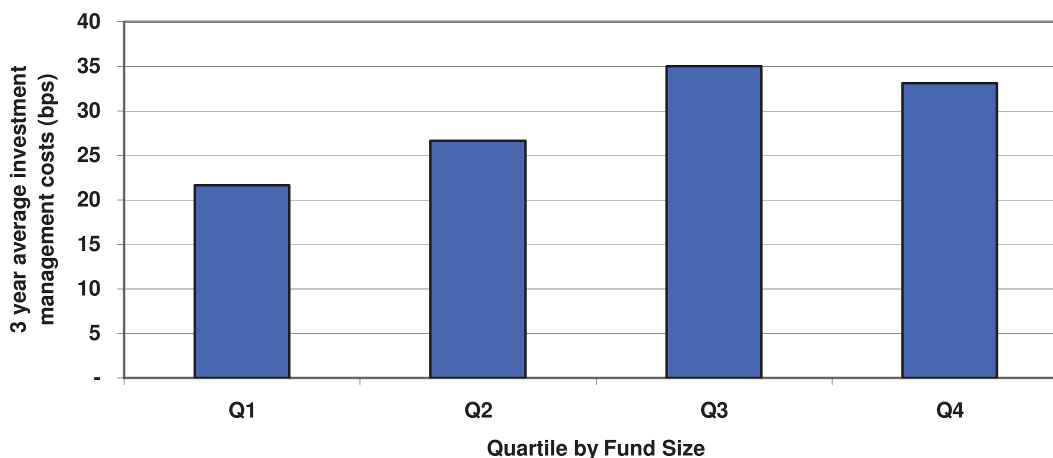
## Management arrangements

There is a significant difference in investment management costs when comparing internally managed funds to externally managed funds.




This graph shows that internally managed funds have investment management costs that are 20bps p.a. lower than externally managed funds, which again suggests that management arrangements are a more important determinant than fund size.

This is also supported by the following graph which shows the investment management costs of externally managed funds only divided into quartiles based on fund size.




This graph shows that larger externally managed funds have lower cost ratios than externally managed smaller funds but the differential (5 – 15bps) is smaller, and the correlation (-0.37) is lower.

A number of the studies in Section 1 highlighted the potential for savings in investment management costs through the merger of funds in order to benefit from economies of scale, although some of the studies acknowledged that there would be significant transition costs which would mitigate a proportion of the savings.

It is possible that a large proportion of these cost savings could be generated without having to resort to the costly and complex process of merging funds, with the associated loss of local accountability, such as:

- Greater collaboration between funds, in a similar way to that seen in recent framework agreements for custodian services and actuarial, benefits, and investment consulting. A framework agreement would certainly increase the level of competition on costs from investment managers. However, it may be harder to develop a framework agreement for investment management services due to the wide ranging and somewhat bespoke nature of the services provided. Nevertheless, it could still be useful for more generic services such as index tracking.

- As part of the tender process for investment management mandates within the LGPS, investment managers could be required to provide that particular service to all interested LGPS funds with a sliding fee scale, to which all participating funds would benefit from, depending on the total assets under management. This would enable LGPS funds to retain the responsibility for asset allocation and manager selection but still benefit from the wider economies of scale within the LGPS.

- A number of LGPS funds have considerable experience and strong performance track records in direct investment in certain asset classes via in-house management. These funds could offer their expertise to other LGPS funds possibly via a unitised or pooled vehicle. Costs are likely to be significantly lower than traditional asset managers, with no

detrimental impact on performance, whilst still covering the costs of additional resources that would be required and permitting a modest profit incentive.

KEY FINDINGS

- Larger funds tend to have lower investment management costs.
- Internally managed funds have significantly lower investment management costs.
- There are a number of alternative methods of achieving cost savings in investment management.

Additional information that would assist in a more detailed analysis:

- Split between internal and external investment management in each LGPS fund to determine whether the correlation between internal management and investment management costs holds for funds with a lower level of internal management.

- Investment management cost data for the entire period under review to determine the trend in costs.

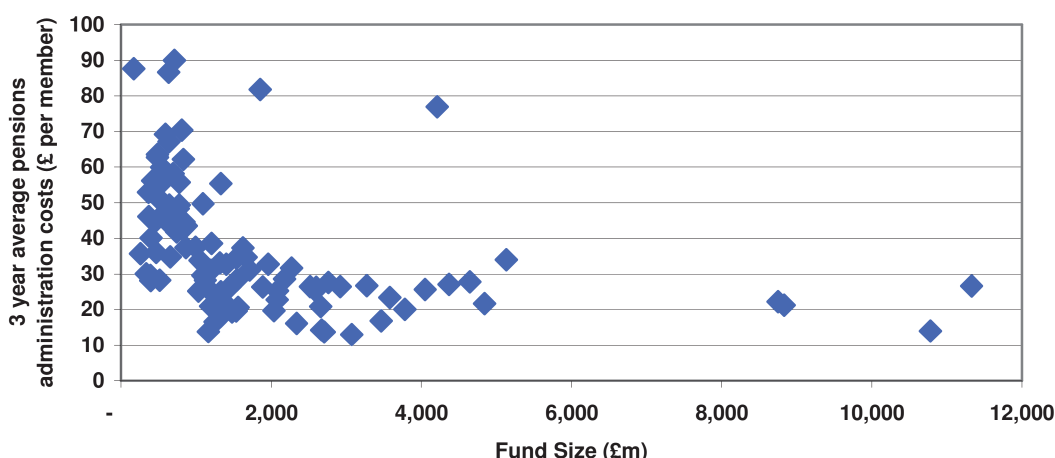
## LGPS PENSION ADMINISTRATION COSTS

The majority of the studies reviewed in the first section concluded that larger funds tended to have lower pension administration costs per member.

This section of the report sought to determine whether larger funds have lower pension administration costs per member than smaller funds and to identify the causes of any differences by analysing the average pension administration costs of the LGPS funds over the three years to 31 March 2012.

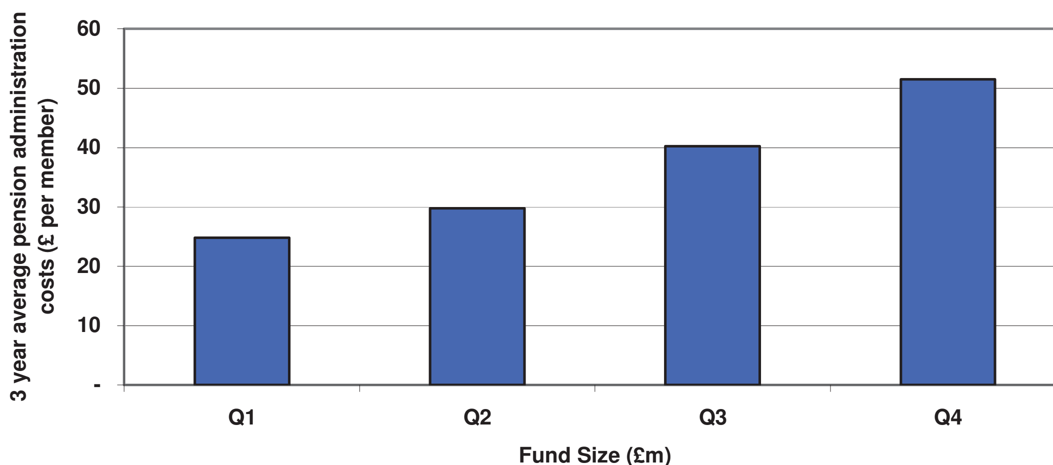
The cost data was collated from the individual annual report and accounts of each LGPS fund and divided by the assets under management at the end of each financial year to provide a 3 year average figure for pension administration costs. This resulted in cost data for all 100 funds under review with the data for each fund shown in Appendix 4.

The average annual cost of pension administration over the 3 year period under analysis was £29.49 per member (range of £12.98 to £89.93). The individual costs of the 100 LGPS funds are shown on the following graph:




As can be seen from the graph, it does appear that there is some correlation between fund size and pension administration costs with larger funds enjoying lower administration per scheme member. This is supported by a correlation coefficient ($r^2$) of -0.39 for the 3 year period to 31 March 2012.

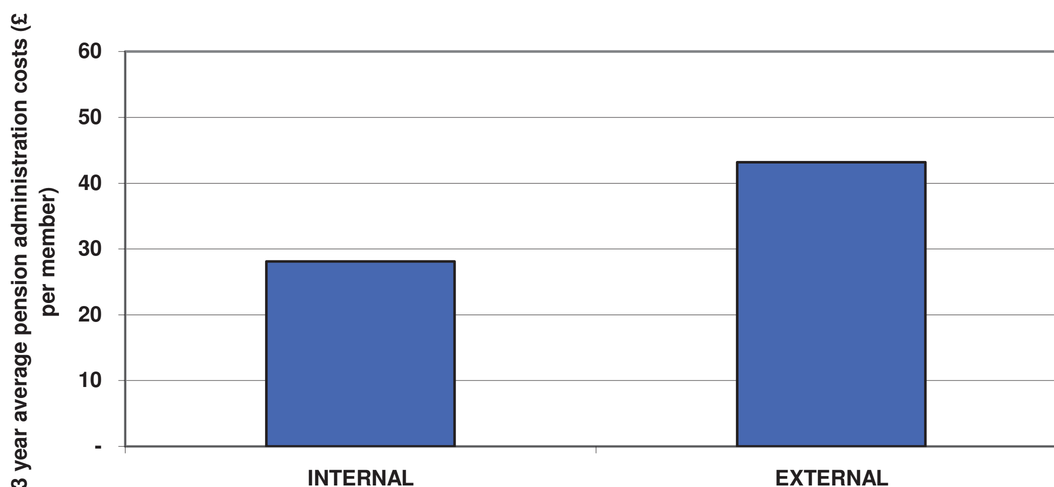
The following graph shows the pension administration costs of the LGPS divided into quartiles based on fund size:




This graph shows that larger funds have pension administration costs that are, on average, £5 – 25 per member p.a. lower than smaller funds, although there is a wide variation within each quartile.

### Administration arrangements

The majority of the LGPS funds (91% of assets) are internally administered and there is a significant difference in pension administration costs when comparing internally administered funds to externally administered funds.




This graph shows that internally administered funds have pension administration costs that are, on average, £15 per member p.a. lower than externally administered funds which suggests that, in addition to fund size, administration arrangements are an important determinant of relative costs.

There are a number of potential issues that the reader should be aware of when comparing administration costs across LGPS funds:

- There are significant variations in service levels across LGPS funds which may have a significant impact on costs;

- There is no standard methodology for reporting pension administration costs across the LGPS; and

- LGPS funds with a materially different member profile (i.e. proportion of active, deferred and pensioner members) or employer profile (i.e. large number of small employers) could have a significantly different cost structure.

KEY FINDINGS

- **Larger funds tend to have lower pension administration costs.**

- **Internally administered funds have significantly lower administration costs.**

Additional information that would assist in a more detailed analysis:

- Service levels in each fund to determine the extent to which the level of service provided correlates with administration costs.

- Pension administration cost data for the entire period under review to determine the trend in costs.

- Fund member data analysed by active, deferred, and pensioner and employer information for the entire period.

- Evidence of the benefit of current collaborations between LGPS funds in pension administration.

## ANALYSIS OF INTERNAL MANAGEMENT

This section of the report will briefly consider the merits for internal management, some of the issues that may arise, and possible solutions.

The previous four sections of this report have provided evidence that the internal management of funds can provide tangible benefits, both for investment management and pension administration. In summary, there is detailed evidence that internally managed funds have:

- Better long term performance (50 – 80bps p.a.);
- Significantly lower transaction costs (20 – 50bps p.a.[1]);
- Lower investment management costs (20bps p.a.); and
- Significantly lower pension administration costs (£15 per member p.a.).

[1] Reflected in the long term performance differential

The main issues arising from internal management are:

- *Fund size.* There are 5 internally managed funds in the LGPS with assets under management ranging from £2.6 – 8.8bn as at 31 March 2012. This suggests that funds need to be of a certain size before considering an internal investment resource. However, this is not necessarily the case as the majority of the current internally managed funds have had an internal investment resource in place for over 20 years, when they were significantly smaller, suggesting that size should not be a major impediment.
- *Increasing complexity.* There is an argument that, in recent years, asset allocation and governance arrangements have become wider ranging and more complex, which suggests that internally managed funds would need to be better resourced and, therefore, larger than may have been the case in the past.
- *Keyman risk and succession planning.* Internally managed funds are, by their nature, relatively small in terms of the number of employees and there is significant keyman risk if staff were to leave. In addition, succession planning can be particularly difficult within a small investment team.
- *Recruitment and retention of staff.* Investment management and pension administration are specialised fields requiring suitable qualifications and extensive knowledge and experience. Therefore, it can be difficult to recruit and retain appropriate staff, particularly in geographic areas where there are no existing comparable private sector resources and particularly within existing local authority pay scales and constraints.

Potential solutions to the issues raised above are:

- *Fund size.* A fund size of £1 – 1.5bn should be sufficient to make a full internal investment resource cost effective when compared to the average costs of an externally managed fund, even with the additional resource requirements that are now required. In addition, funds do not necessarily have to set up a full internal investment resource to start with and could increase the level of internal resources over time. This would also avoid the potential issue of recruiting sufficient numbers of appropriately qualified and experienced investment personnel all at one time.

- *Realistic and competitive remuneration.* Local authorities need to recognise that they must offer a remuneration structure that is sufficient to attract and retain appropriately qualified and experienced staff. This is likely to be incompatible with the current local authority remuneration structure but would still offer a significant cost benefit compared to the alternative of external management, as demonstrated on pages 28 – 34. One alternative structure would be to follow the Canadian public sector pension fund model whereby a quasi-independent entity, which could still be majority-owned by the local authority, is created which would permit the decoupling of remuneration from the existing local authority pay structure.

KEY FINDINGS

- Internally managed funds offer an attractive alternative in terms of long term performance and cost efficiency.

- The key issues for internal management are fund size, keyman risk and succession planning, and recruitment and retention of staff.

## APPENDIX 1: LGPS INVESTMENT PERFORMANCE FOR THE 10 YEARS ENDED 31 MARCH 2012

| | Fund | Size (£m) | Performance (% p.a.) |
|---|---|---|---|
| 1 | Strathclyde[1] | 11,327 | 5.8 |
| 2 | Greater Manchester[1] | 10,781 | 6.3 |
| 3 | West Midlands[2] | 8,834 | 5.4 |
| 4 | West Yorkshire[1] | 8,752 | 6.4 |
| 5 | Merseyside[1] | 5,130 | 6.1 |
| 6 | Tyne and Wear[1] | 4,841 | 6.1 |
| 7 | South Yorkshire[1] | 4,647 | 6.5 |
| 8 | Lancashire[1] | 4,370 | 5.6 |
| 9 | London Pension Fund Authority[3] | 4,214 | 5.0 |
| 10 | Northern Ireland[2] | 4,052 | 5.9 |
| 11 | Hampshire[4] | 3,777 | 5.6 |
| 12 | Lothian[1] | 3,581 | 6.2 |
| 13 | Essex[1] | 3,464 | 6.0 |
| 14 | Kent[1] | 3,273 | 5.5 |
| 15 | Nottinghamshire[1] | 3,072 | 5.7 |
| 16 | Cheshire[1] | 2,920 | 5.7 |
| 17 | Avon[1] | 2,762 | 5.8 |
| 18 | Derbyshire[1] | 2,709 | 6.2 |
| 19 | Devon[1] | 2,673 | 6.0 |
| 20 | East Riding of Yorkshire[1] | 2,659 | 6.1 |
| 21 | Staffordshire[1] | 2,600 | 5.7 |
| 22 | Teesside[1] | 2,587 | 6.7 |
| 23 | Hertfordshire[1] | 2,521 | 4.3 |

| | Fund | Size (£m) | Performance (% p.a.) |
|---|---|---|---|
| 24 | Leicestershire[4] | 2,337 | 4.4 |
| 25 | North East Scotland[2] | 2,269 | 5.8 |
| 26 | Norfolk[1] | 2,176 | 5.1 |
| 27 | East Sussex[1] | 2,082 | 5.8 |
| 28 | Surrey[1] | 2,079 | 5.5 |
| 29 | West Sussex[1] | 2,037 | 6.5 |
| 30 | Tayside[4] | 1,959 | 5.9 |
| 31 | Environment Agency – Active[1] | 1,852 | 4.5 |
| 32 | Rhonda Cynon Taff[1] | 1,714 | 5.6 |
| 33 | Torfaen[1] | 1,666 | 5.7 |
| 34 | Cambridgeshire[1] | 1,624 | 5.0 |
| 35 | Dorset[1] | 1,562 | 5.2 |
| 36 | Buckinghamshire[1] | 1,544 | 5.0 |
| 37 | Suffolk[1] | 1,540 | 5.3 |
| 38 | North Yorkshire[1] | 1,535 | 4.6 |
| 39 | Worcestershire[1] | 1,479 | 5.1 |
| 40 | Cumbria[1] | 1,454 | 5.7 |
| 41 | Carmarthenshire[1] | 1,403 | 6.4 |
| 42 | Northamptonshire[1] | 1,331 | 5.0 |
| 43 | Wiltshire[1] | 1,329 | 4.7 |
| 44 | Lincolnshire[1] | 1,328 | 4.8 |
| 45 | Bedfordshire[1] | 1,301 | 4.3 |
| 46 | Oxfordshire[1] | 1,296 | 4.9 |
| 47 | Falkirk[1] | 1,252 | 5.5 |
| 48 | Warwickshire[1] | 1,205 | 5.6 |

| | Fund | Size (£m) | Performance (% p.a.) |
|---|---|---|---|
| 49 | Gloucestershire[1] | 1,198 | 5.2 |
| 50 | Somerset[1] | 1,192 | 4.8 |
| 51 | Cornwall[1] | 1,165 | 5.1 |
| 52 | Cardiff and Vale of Glamorgan[1] | 1,150 | 5.7 |
| 53 | Swansea[1] | 1,124 | 5.8 |
| 54 | Flintshire[1] | 1,091 | 5.4 |
| 55 | Shropshire[1] | 1,087 | 5.2 |
| 56 | Gwynedd[1] | 1,048 | 5.3 |
| 57 | Camden[1] | 996 | 5.8 |
| 58 | Southwark[1] | 873 | 5.6 |
| 59 | Wandsworth[1] | 861 | 6.2 |
| 60 | Tower Hamlets[1] | 830 | 5.1 |
| 61 | Hackney[1] | 815 | 5.5 |
| 62 | Islington[1] | 808 | 4.9 |
| 63 | Lewisham[1] | 773 | 4.4 |
| 64 | Greenwich[1] | 759 | 4.7 |
| 65 | Northumberland[1] | 744 | 6.2 |
| 66 | Newham[1] | 740 | 5.0 |
| 67 | Barnet[1] | 709 | 5.7 |
| 68 | Ealing[1] | 691 | 5.8 |
| 69 | Haringey[1] | 653 | 4.5 |
| 70 | Enfield[1] | 644 | 5.6 |
| 71 | Hammersmith and Fulham[1] | 638 | 6.6 |
| 72 | Croydon[1] | 635 | 4.9 |
| 73 | City of London[1] | 604 | 5.2 |

| | Fund | Size (£m) | Performance (% p.a.) |
|---|---|---|---|
| 74 | Hounslow[1] | 591 | 7.0 |
| 75 | Barking[1] | 577 | 4.2 |
| 76 | Waltham Forest[1] | 539 | 5.6 |
| 77 | Dumfries and Galloway[1] | 515 | 3.7 |
| 78 | Bromley[1] | 500 | 7.0 |
| 79 | Harrow[1] | 489 | 5.4 |
| 80 | Brent[1] | 485 | 2.7 |
| 81 | Bexley[1] | 483 | 5.9 |
| 82 | Redbridge[1] | 469 | 5.8 |
| 83 | Richmond[1] | 448 | 6.0 |
| 84 | Kingston[1] | 423 | 5.3 |
| 85 | Havering[1] | 401 | 4.5 |
| 86 | Merton[1] | 397 | 6.1 |
| 87 | Scottish Borders[1] | 392 | 6.0 |
| 88 | Powys[1] | 372 | 5.4 |
| 89 | Sutton[1] | 366 | 4.9 |
| 90 | Isle of Wight[1] | 335 | 6.3 |
| 91 | Shetland Islands[1] | 260 | 4.4 |
| 92 | Orkney Islands[1] | 169 | 7.3 |
| | | **176,938** | **5.7** |

[1] CIPFA “Local Authority Pension Fund Investment Statistics 2002 – 2012”
[2] Individual fund annual report and accounts
[3] Performance data is a combination of 65% Active Sub-Fund and 35% Pensioner Sub-Fund based on average fund sizes over the period 2009 – 12 – individual performance data for the 10 year period is 4.1% p.a. for the Active Sub-Fund and 6.7% p.a. for the Pensioner Sub-Fund
[4] Confirmed by administering authority

## APPENDIX 2: LGPS INVESTMENT PERFORMANCE FOR THE 20 YEARS ENDED 31 MARCH 2012

| | Fund | Size (£m) | Performance (% p.a.) |
|---|---|---|---|
| 1 | Strathclyde | 11,327 | 8.8 |
| 2 | Greater Manchester | 10,781 | 9.5 |
| 3 | West Yorkshire | 8,752 | 9.2 |
| 4 | Merseyside | 5,130 | 8.9 |
| 5 | South Yorkshire | 4,647 | 8.8 |
| 6 | Lancashire | 4,370 | 8.5 |
| 7 | London Pension Fund Authority | 4,214 | 7.6 |
| 8 | Kent | 3,273 | 8.3 |
| 9 | Derbyshire | 2,709 | 9.0 |
| 10 | Devon | 2,673 | 8.6 |
| 11 | East Riding of Yorkshire | 2,659 | 8.7 |
| 12 | Staffordshire | 2,600 | 8.6 |
| 13 | Teesside | 2,587 | 9.4 |
| 14 | Hertfordshire | 2,521 | 8.0 |
| 15 | Leicestershire | 2,337 | 7.9 |
| 16 | North East Scotland | 2,269 | 8.9 |
| 17 | Norfolk | 2,176 | 8.7 |
| 18 | East Sussex | 2,082 | 8.9 |
| 19 | Surrey | 2,079 | 8.1 |
| 20 | West Sussex | 2,037 | 9.3 |
| 21 | Tayside | 1,959 | 8.6 |
| 22 | Rhonda Cynon Taff | 1,714 | 8.3 |
| 23 | Torfaen | 1,666 | 8.1 |
| 24 | Cambridgeshire | 1,624 | 8.1 |

| | Fund | Size (£m) | Performance (% p.a.) |
|---|---|---|---|
| 25 | Dorset | 1,562 | 8.6 |
| 26 | Buckinghamshire | 1,544 | 7.6 |
| 27 | Suffolk | 1,540 | 8.4 |
| 28 | North Yorkshire | 1,535 | 7.9 |
| 29 | Worcestershire | 1,479 | 8.5 |
| 30 | Cumbria | 1,454 | 8.8 |
| 31 | Carmarthenshire | 1,403 | 9.2 |
| 32 | Northamptonshire | 1,331 | 8.5 |
| 33 | Wiltshire | 1,329 | 8.0 |
| 34 | Oxfordshire | 1,296 | 8.1 |
| 35 | Falkirk | 1,252 | 8.6 |
| 36 | Warwickshire | 1,205 | 8.6 |
| 37 | Gloucestershire | 1,198 | 8.5 |
| 38 | Somerset | 1,192 | 8.4 |
| 39 | Cardiff and Vale of Glamorgan | 1,150 | 8.4 |
| 40 | Swansea | 1,124 | 8.6 |
| 41 | Flintshire | 1,091 | 8.3 |
| 42 | Gwynedd | 1,048 | 8.3 |
| 43 | Camden | 996 | 8.9 |
| 44 | Southwark | 873 | 8.8 |
| 45 | Wandsworth | 861 | 9.2 |
| 46 | Tower Hamlets | 830 | 8.1 |
| 47 | Hackney | 815 | 8.7 |
| 48 | Islington | 808 | 8.5 |
| 49 | Lewisham | 773 | 8.4 |

| | Fund | Size (£m) | Performance (% p.a.) |
|---|---|---|---|
| 50 | Northumberland | 744 | 8.4 |
| 51 | Newham | 740 | 7.6 |
| 52 | Barnet | 709 | 8.3 |
| 53 | Ealing | 691 | 9.1 |
| 54 | Haringey | 653 | 7.8 |
| 55 | Enfield | 644 | 8.9 |
| 56 | Hammersmith and Fulham | 638 | 8.5 |
| 57 | Croydon | 635 | 7.5 |
| 58 | City of London | 604 | 7.8 |
| 59 | Barking | 577 | 8.4 |
| 60 | Waltham Forest | 539 | 8.6 |
| 61 | Dumfries and Galloway | 515 | 8.1 |
| 62 | Bromley | 500 | 9.1 |
| 63 | Harrow | 489 | 8.7 |
| 64 | Brent | 485 | 7.0 |
| 65 | Bexley | 483 | 9.1 |
| 66 | Redbridge | 469 | 8.7 |
| 67 | Richmond | 448 | 8.7 |
| 68 | Kingston | 423 | 8.0 |
| 69 | Havering | 401 | 8.4 |
| 70 | Merton | 397 | 8.9 |
| 71 | Scottish Borders | 392 | 8.9 |
| 72 | Powys | 372 | 7.7 |
| 73 | Sutton | 366 | 8.0 |
| 74 | Shetland Islands | 260 | 8.0 |

| | Fund | Size (£m) | Performance (% p.a.) |
|---|---|---|---|
| 75 | Orkney Islands | 169 | 9.7 |
| | | **131,215** | **8.6** |

All data in this table uses 10 year annualised performance data from the CIPFA "Local Authority Pension Fund Investment Statistics 1992 – 2002" compounded with the data in Appendix 1 for all funds that had available data for both periods.

## APPENDIX 3: LGPS INVESTMENT MANAGEMENT COSTS FOR THE 3 YEARS ENDED 31 MARCH 2012

| | Fund | Size (£m) | 3 year average (% of assets) |
|---|---|---|---|
| 1 | Strathclyde | 11,327 | 0.13 |
| 2 | Greater Manchester | 10,781 | 0.09 |
| 3 | West Midlands | 8,834 | 0.12 |
| 4 | West Yorkshire | 8,752 | 0.02 |
| 5 | Merseyside | 5,130 | 0.21 |
| 6 | Tyne and Wear | 4,841 | 0.19 |
| 7 | South Yorkshire | 4,647 | 0.04 |
| 8 | Lancashire | 4,370 | 0.18 |
| 9 | London Pension Fund Authority | 4,214 | 0.30 |
| 10 | Northern Ireland | 4,052 | 0.28 |
| 11 | Hampshire | 3,777 | 0.27 |
| 12 | Lothian | 3,581 | 0.27 |
| 13 | Essex | 3,464 | 0.43 |
| 14 | Kent | 3,273 | 0.25 |
| 15 | Nottinghamshire | 3,072 | 0.14 |
| 16 | Cheshire | 2,920 | 0.30 |
| 17 | Avon | 2,762 | 0.30 |
| 18 | Derbyshire | 2,709 | 0.14 |
| 19 | Devon | 2,673 | 0.16 |
| 20 | East Riding of Yorkshire | 2,659 | 0.10 |
| 21 | Staffordshire | 2,600 | 0.30 |
| 22 | Teesside | 2,587 | 0.05 |
| 23 | Hertfordshire | 2,521 | 0.37 |

| | Fund | Size (£m) | 3 year average (% of assets) |
|---|---|---|---|
| 24 | Leicestershire | 2,337 | 0.31 |
| 25 | North East Scotland | 2,269 | 0.30 |
| 26 | Norfolk | 2,176 | 0.37 |
| 27 | East Sussex | 2,082 | 0.27 |
| 28 | Surrey | 2,079 | 0.29 |
| 29 | West Sussex | 2,037 | 0.21 |
| 30 | Tayside | 1,959 | 0.30 |
| 31 | Durham | 1,889 | 0.36 |
| 32 | Environment Agency – Active | 1,852 | 0.31 |
| 33 | Rhonda Cynon Taff | 1,714 | 0.25 |
| 34 | Torfaen | 1,666 | 0.24 |
| 35 | Cambridgeshire | 1,624 | 0.32 |
| 36 | Dorset | 1,562 | 0.12 |
| 37 | Buckinghamshire | 1,544 | 0.22 |
| 38 | Suffolk | 1,540 | 0.36 |
| 39 | North Yorkshire | 1,535 | 0.31 |
| 40 | Worcestershire | 1,479 | 0.23 |
| 41 | Cumbria | 1,454 | 0.22 |
| 42 | Berkshire | 1,453 | 0.17 |
| 43 | Carmarthenshire | 1,403 | 0.08 |
| 44 | Northamptonshire | 1,331 | 0.30 |
| 45 | Wiltshire | 1,329 | 0.31 |
| 46 | Lincolnshire | 1,328 | 0.27 |
| 47 | Fife | 1,317 | 0.36 |
| 48 | Bedfordshire | 1,301 | 0.32 |

| | Fund | Size (£m) | 3 year average (% of assets) |
|---|---|---|---|
| 49 | Oxfordshire | 1,296 | 0.22 |
| 50 | Falkirk | 1,252 | 0.27 |
| 51 | Warwickshire | 1,205 | 0.33 |
| 52 | Gloucestershire | 1,198 | 0.27 |
| 53 | Somerset | 1,192 | 0.32 |
| 54 | Cornwall | 1,165 | 0.35 |
| 55 | Cardiff and Vale of Glamorgan | 1,150 | 0.32 |
| 56 | Swansea | 1,124 | 0.39 |
| 57 | Flintshire | 1,091 | 0.47 |
| 58 | Shropshire | 1,087 | 0.70 |
| 59 | Gwynedd | 1,048 | 0.36 |
| 60 | Highland | 1,033 | 0.25 |
| 61 | Camden | 996 | 0.26 |
| 62 | Southwark | 873 | 0.52 |
| 63 | Wandsworth | 861 | 0.29 |
| 64 | Lambeth | 839 | 0.26 |
| 65 | Tower Hamlets | 830 | 0.26 |
| 66 | Hackney | 815 | 0.31 |
| 67 | Islington | 808 | 0.16 |
| 68 | Westminster | 774 | 0.45 |
| 69 | Lewisham | 773 | 0.23 |
| 70 | Greenwich | 759 | 0.26 |
| 71 | Northumberland | 744 | 0.22 |
| 72 | Newham | 740 | 0.40 |
| 73 | Barnet | 709 | 0.35 |

| | Fund | Size (£m) | 3 year average (% of assets) |
|---|---|---|---|
| 74 | Ealing | 691 | 0.34 |
| 75 | Haringey | 653 | 0.45 |
| 76 | Enfield | 644 | 0.18 |
| 77 | Hammersmith and Fulham | 638 | 0.55 |
| 78 | Croydon | 635 | 0.25 |
| 79 | Hillingdon | 610 | 0.54 |
| 80 | City of London | 604 | 0.52 |
| 81 | Hounslow | 591 | 0.23 |
| 82 | Barking | 577 | 0.41 |
| 83 | Kensington and Chelsea | 541 | 0.40 |
| 84 | Waltham Forest | 539 | 0.44 |
| 85 | Dumfries and Galloway | 515 | 0.33 |
| 86 | Bromley | 500 | 0.40 |
| 87 | Harrow | 489 | 0.07 |
| 88 | Brent | 485 | 0.39 |
| 89 | Bexley | 483 | 0.28 |
| 90 | Redbridge | 469 | 0.34 |
| 91 | Richmond | 448 | 0.23 |
| 92 | Kingston | 423 | 0.29 |
| 93 | Havering | 401 | 0.32 |
| 94 | Merton | 397 | 0.17 |
| 95 | Scottish Borders | 392 | 0.32 |
| 96 | Powys | 372 | 0.37 |
| 97 | Sutton | 366 | 0.33 |
| 98 | Isle of Wight | 335 | 0.30 |

| | Fund | Size (£m) | 3 year average (% of assets) |
|---|---|---|---|
| 99 | Shetland Islands | 260 | 0.16 |
| 100 | Orkney Islands | 169 | 0.23 |
| | | **185,393** | **0.23** |

## APPENDIX 3: LGPS PENSION ADMINISTRATION COSTS FOR THE 3 YEARS ENDED 31 MARCH 2012

| | Fund | Size (£m) | 3 year average (£ per member) |
|---|---|---|---|
| 1 | Strathclyde[1] | 11,327 | 26.66 |
| 2 | Greater Manchester[1] | 10,781 | 14.03 |
| 3 | West Midlands[1] | 8,834 | 21.25 |
| 4 | West Yorkshire[1] | 8,752 | 22.24 |
| 5 | Merseyside[1] | 5,130 | 33.99 |
| 6 | Tyne and Wear[1] | 4,841 | 21.69 |
| 7 | South Yorkshire[1] | 4,647 | 27.84 |
| 8 | Lancashire[1] | 4,370 | 27.12 |
| 9 | London Pension Fund Authority[1] | 4,214 | 76.94 |
| 10 | Northern Ireland[1] | 4,052 | 25.65 |
| 11 | Hampshire[1] | 3,777 | 20.09 |
| 12 | Lothian[1] | 3,581 | 23.42 |
| 13 | Essex[1] | 3,464 | 16.87 |
| 14 | Kent[1] | 3,273 | 26.70 |
| 15 | Nottinghamshire[1] | 3,072 | 12.98 |
| 16 | Cheshire[1] | 2,920 | 26.42 |
| 17 | Avon[1] | 2,762 | 27.62 |
| 18 | Derbyshire[1] | 2,709 | 13.71 |
| 19 | Devon[1] | 2,673 | 14.25 |
| 20 | East Riding of Yorkshire[1] | 2,659 | 20.92 |
| 21 | Staffordshire[1] | 2,600 | 26.24 |
| 22 | Teesside[2] | 2,587 | 25.40 |
| 23 | Hertfordshire[2] | 2,521 | 26.44 |

| | Fund | Size (£m) | 3 year average (£ per member) |
|---|---|---|---|
| 24 | Leicestershire[1] | 2,337 | 16.15 |
| 25 | North East Scotland[1] | 2,269 | 31.65 |
| 26 | Norfolk[1] | 2,176 | 28.65 |
| 27 | East Sussex[2] | 2,082 | 25.26 |
| 28 | Surrey[1] | 2,079 | 22.81 |
| 29 | West Sussex[1] | 2,037 | 19.75 |
| 30 | Tayside[1] | 1,959 | 32.72 |
| 31 | Durham[1] | 1,889 | 26.40 |
| 32 | Environment Agency – Active[2] | 1,852 | 81.75 |
| 33 | Rhonda Cynon Taff[1] | 1,714 | 31.10 |
| 34 | Torfaen[1] | 1,666 | 34.68 |
| 35 | Cambridgeshire[1] | 1,624 | 37.31 |
| 36 | Dorset[1] | 1,562 | 20.61 |
| 37 | Buckinghamshire[1] | 1,544 | 28.30 |
| 38 | Suffolk[1] | 1,540 | 34.46 |
| 39 | North Yorkshire[1] | 1,535 | 19.66 |
| 40 | Worcestershire[1] | 1,479 | 19.38 |
| 41 | Cumbria[1] | 1,454 | 26.49 |
| 42 | Berkshire[1] | 1,453 | 20.32 |
| 43 | Carmarthenshire[1] | 1,403 | 32.76 |
| 44 | Northamptonshire[1] | 1,331 | 55.32 |
| 45 | Wiltshire[1] | 1,329 | 25.04 |
| 46 | Lincolnshire[2] | 1,328 | 18.08 |
| 47 | Fife[1] | 1,317 | 33.07 |

| | Fund | Size (£m) | 3 year average (£ per member) |
|---|---|---|---|
| 48 | Bedfordshire[1] | 1,301 | 22.71 |
| 49 | Oxfordshire[1] | 1,296 | 23.63 |
| 50 | Falkirk[1] | 1,252 | 16.62 |
| 51 | Warwickshire[1] | 1,205 | 38.60 |
| 52 | Gloucestershire[1] | 1,198 | 30.99 |
| 53 | Somerset[1] | 1,192 | 21.01 |
| 54 | Cornwall[1] | 1,165 | 13.85 |
| 55 | Cardiff and Vale of Glamorgan[1] | 1,150 | 26.21 |
| 56 | Swansea[1] | 1,124 | 28.25 |
| 57 | Flintshire[1] | 1,091 | 49.70 |
| 58 | Shropshire[1] | 1,087 | 29.60 |
| 59 | Gwynedd[1] | 1,048 | 33.77 |
| 60 | Highland[1] | 1,033 | 25.20 |
| 61 | Camden[1] | 996 | 37.49 |
| 62 | Southwark[1] | 873 | 43.48 |
| 63 | Wandsworth[1] | 861 | 37.35 |
| 64 | Lambeth[1] | 839 | 44.58 |
| 65 | Tower Hamlets[1] | 830 | 62.16 |
| 66 | Hackney[2] | 815 | 42.51 |
| 67 | Islington[1] | 808 | 70.41 |
| 68 | Westminster[2] | 774 | 55.69 |
| 69 | Lewisham[1] | 773 | 49.37 |
| 70 | Greenwich[1] | 759 | 48.34 |
| 71 | Northumberland[1] | 744 | 45.74 |

| | Fund | Size (£m) | 3 year average (£ per member) |
|---|---|---|---|
| 72 | Newham[2] | 740 | 41.76 |
| 73 | Barnet[1] | 709 | 89.93 |
| 74 | Ealing[2] | 691 | 58.13 |
| 75 | Haringey[1] | 653 | 34.84 |
| 76 | Enfield[1] | 644 | 49.33 |
| 77 | Hammersmith and Fulham[2] | 638 | 67.14 |
| 78 | Croydon[1] | 635 | 86.61 |
| 79 | Hillingdon[1] | 610 | 44.73 |
| 80 | City of London[1] | 604 | 47.73 |
| 81 | Hounslow[2] | 591 | 69.27 |
| 82 | Barking[1] | 577 | 45.70 |
| 83 | Kensington and Chelsea[2] | 541 | 59.93 |
| 84 | Waltham Forest[2] | 539 | 55.53 |
| 85 | Dumfries and Galloway[1] | 515 | 28.23 |
| 86 | Bromley[2] | 500 | 51.17 |
| 87 | Harrow[1] | 489 | 51.35 |
| 88 | Brent[2] | 485 | 63.60 |
| 89 | Bexley[2] | 483 | 62.75 |
| 90 | Redbridge[1] | 469 | 36.09 |
| 91 | Richmond[1] | 448 | 44.54 |
| 92 | Kingston[1] | 423 | 56.18 |
| 93 | Havering[1] | 401 | 40.10 |
| 94 | Merton[1] | 397 | 28.12 |
| 95 | Scottish Borders[1] | 392 | 29.60 |

| | Fund | Size (£m) | 3 year average (£ per member) |
|---|---|---|---|
| 96 | Powys[1] | 372 | 46.11 |
| 97 | Sutton[1] | 366 | 52.95 |
| 98 | Isle of Wight[1] | 335 | 30.03 |
| 99 | Shetland Islands[1] | 260 | 35.68 |
| 100 | Orkney Islands[1] | 169 | 87.66 |
| | | **185,393** | **29.49** |

[1] Internally administered funds
[2] Externally administered funds

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11 September, 2013 | By Ruth Keeling Local Government Chronicle online

Any suggestion that merger of the 89 English local government pension fund will help reduce deficits is “nonsense”, a senior actuary has warned.

Although collaboration and merger could produce some advantages in terms of administration and governance, there was no evidence that bigger funds had better investment returns, fund managers were told last week.

Hymans Robertson senior partner Ronnie Bowie said Local Government Pension Scheme managers and members had to emphasise the lack of evidence for mergers as minsters gathered evidence on closer working.

“There is no correlation between size [of fund] and return and you really do need to keep banging away at that message with [the Department for Communities & Local Government],” he told delegates at the LGC Investment Summit.

Mr Bowie presented analysis of the average investment return of all 89 funds over a five year period which showed the average was 3% and he pointed to four different funds which had the same average return – one of £300m, one of £600m, one of £2bn and one of £8bn.

“If your argument is that big funds do better than small funds, that is nonsense,” he said.

Using strong language, he also said any argument that a merger would reduce the LGPS deficit between assets and liabilities “because somehow your ‘wastefulness’ will be eliminated” was completely wrong.

However, his analysis did reveal that there were smaller variations between the average investment returns of larger funds.

“If part of the motivation of pooling assets and thinking about mergers is to accept that you have to lose some of the very best but you are going to eliminate some of the very worst, then I can see an argument,” he said.

He also said there were valid arguments that bigger funds might make it easier to access “difficult” asset classes such as private equity and might make in-house management of investment choices easier.

Fund managers at the conference were preparing to respond to a call for evidence on the structure of LGPS issued by local government minister Brandon Lewis (Con) earlier this year.

Speaking in a parliamentary debate on Tuesday, Mr Lewis said he was “concerned by the mixed performance across the board, with inconsistency in investment performance and variation of fund management costs across the 89 funds”.

He said he “would not shy away from reducing the number of funds if that is what it takes to improve the efficiency and cost-effectiveness of the scheme”, but also said it was “important for me and the government to keep an open mind during the call for evidence”.

Due to close this month, it is likely to elicit strong views from local government.

Pressure to collaborate is strongest on council pension funds in London, of which there are more than 30. More than half of these have assets under £500m compared to the average local government fund size of £1.5bn. They also have some of the lowest funding levels, with some as low as 60%.

The Society of London Treasurers is currently drawing up plans for a joint asset vehicle for equities investments.

Speaking at the LGC Investment Summit, Barking & Dagenham LBC chief finance officer Jonathan Bunt said this would need to be extended to other assets if the pension funds were to avoid having a joint working initiative forced on them.

“Some convergence is essential,” he said. “If we don’t it will be imposed on us probably in the next two years,” he added.

[ends]