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SOUTH YORKSHIRE
PENSIONS AUTHORITY

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NOTICE OF AUTHORITY MEETING

You are hereby summoned to a meeting of the South Yorkshire Pensions Authority to be held at the offices of the South Yorkshire Joint Secretariat on Tuesday 8 July 2014 at 9.30 am for the purpose of transacting the business set out in the agenda.

Diana Terris

Diana Terris
Clerk

This Matter is being dealt with by:	Gill Garrety	Tel: 01226 772806
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Councillors R Wraith (Vice-Chair), E Butler, J Campbell, S Ellis, R Ford, B Lodge, K Rodgers, L Rooney, A Sangar, M Stowe, P Wootton and B Webster

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SOUTH YORKSHIRE PENSIONS AUTHORITY

8 JULY 2014 AT 9.30 AM AT THE OFFICES OF THE SOUTH YORKSHIRE JOINT SECRETARIAT, 18 REGENT STREET, BARNSLEY

Agenda: Reports attached unless stated otherwise

	Item	**Page**
1	Apologies	
2	Urgent Items 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.	
3	Items to be considered in the absence of the public and press. 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).	
4	Declarations of Interest.	
5	LGPS Consultation: Opportunities for Collaboration, Cost Savings and Efficiencies	1 - 18

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SOUTH YORKSHIRE PENSIONS AUTHORITY

Report of the Fund Director

8 JULY 2014

LGPS CONSULTATION: OPPORTUNITIES FOR COLLABORATION, COST SAVINGS AND EFFICIENCIES

1) Purpose of the report

To seek Members' comments on a draft response to the Government's consultation in response to the call for evidence into the future structure of the Local Government Pension Scheme.

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2) Recommendation

That Members' consider the Authority's draft response to the consultation.

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3) Background information

3.1 I reported to the Authority last month that the Government had announced its latest consultation on reform of the LGPS. This one focuses upon potential savings arising out of the establishment of so-called common investment vehicles (CIVs) and their use by LGPS administering authorities, for both listed and alternative asset classes and for the greater use of passive management for all listed assets, including equities and bonds. The documents purport to show that savings of up to £660m can be achieved in this way. Asset allocation decisions will remain with local fund authorities but they will be presented with a list of pre-selected funds to choose from. The exercise is clearly focussed upon cost savings.

3.2 To support the consultation CLG commissioned research from Hymans Robertson to try to establish comprehensive and standardised data on the true cost of investment across the LGPS and the performance achieved.

3.3 At the same time the Government has argued that if such savings are achieved the level of fund deficits will be significantly reduced.

3.4 It is clear that full fund mergers have been ruled out at least for now.

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3.5 If the recommendations put forward are adopted on a mandatory basis across all LGPS funds there would be major implications for governance at administering authority level as well as portfolio level.

3.6 Attached to my June report were the CLG consultation document (25 pages) and the Hymans Robertson report (106 pages). These will be referred to at today's meeting. If accepted, these proposals will have significant implications for the Scheme, the Authority, the Fund and employees.

3.7 The consultation closes at 11.45 am on 11 July 2014.

4) Implications

4.1 Financial

There will be potentially significant implications for the Authority if these proposals are implemented depending upon the exact nature of the outcome.

4.2 Legal

There will be potentially significant implications for the Authority if these proposals are implemented depending upon the exact nature of the outcome.

4.3 Diversity

There are no diversity implications.

4.4 Risk

There are risks associated with this report but the details will necessarily have to await the outcome of the consultation.

John Hattersley
Fund Director

Telephone contact 01226 772873

Background papers used in the preparation of this report are available for inspection at the offices of the South Yorkshire Pensions Authority

Other sources and references: CLG; Hymans Robertson;

LGPS CONSULTATION: OPPORTUNITIES FOR COLLABORATION, COST SAVINGS AND EFFICIENCIES

Thank you for the opportunity to comment upon the Department's latest call for evidence on the future structure of the Local Government Pension Scheme.

As you are aware this Authority is an administering authority of the Local Government Pension Scheme (LGPS) and manages a Fund currently valued at £5.6bn. It provides pension services to approximately 140,000 individuals, has roughly three hundred employers and ranks as one of the top fifty pension funds in the country.

As a standalone and single purpose Authority Members believe it conducts its matters in an extremely transparent manner and is in the forefront of best practice. It is internally managed, both in terms of pension administration and investment management, and consistently features in the top rankings of funds in terms of both performance and efficiency.

The format of this response is driven by the Authority's concerns that the consultation is too prescriptive and that the formal questions posed are too limited. The reform of the LGPS is not a task that should be undertaken lightly. As the consultation notes the LGPS is one of the largest funded pension schemes in Europe (the report quotes aggregate assets of £178bn as at March 2013 with roughly 4.7m members) and it is, therefore, important that any decisions taken are based upon a sound and robust understanding of the issues the LGPS faces and the ramifications of any changes imposed.

Accordingly, the first part of this response consists of general observations relating to the consultation. The second part focuses more on aspects of the Hymans Robertson report. The third part is the Authority's answers to the specific questions posed (but these should be read in conjunction with the whole response) and this is followed by an appendix on collaboration on alternative investments.

OBSERVATIONS

The original primary objectives of the review were to reduce deficits and improve investment returns so as to ensure that going forward the LGPS was both sustainable and affordable. These key objectives have been abandoned apparently because of their complexity and timescale. Instead, the superficially easier task of reducing investment management costs has been focused upon (because in absolute terms the sums are large) despite the fact that in the context of the total costs incurred by the LGPS they are relatively low. According to the report the total cost to employers in 2012-13 was £6.2bn but investment costs only accounted for £409m of these ie 6.6%. The gains to be made from controlling or reducing deficits and considering how investment performance could be improved would far outweigh the cost savings addressed within the consultation document. Indeed, even though the benefits receivable under the LGPS were recently reviewed as part of the 2014 Scheme structure it can be argued that they remain generous. Whilst it has to be recognised that cost savings can be achieved one of the unintended consequences of this review is that attention is being diverted away from tackling deficits and reducing employer contributions ie 93.4% of costs.

The two main drivers behind the increase in deficits are lower interest rates and bond yields and greater longevity. These have led to a marked increase in the cost of pension provision. These factors are not mentioned in the Hymans Robertson report.

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It is to be welcomed that Government has now ruled out – at least for the time being - mergers of the 89 funds in England and Wales. It is also to be welcomed that the review recognises the need for local accountability and the strength that brings to fund governance. But the thrust of the Hymans Robertson report is to centralise investment management and so reduce the number of accessible options available to funds. It offers less flexibility than individual funds pursuing their own strategies and implementation. It is possible that if all funds have to use the collective vehicles some will face an increase in costs and/or reduced returns and could end up subsidising others.

The report also advocates the wider adoption of passive investment management on the basis of cost. Indeed, initial analysis seems to indicate that some of the assumptions used by Hymans Robertson in creating a total LGPS fund upon which to conduct their modelling can be challenged. It is accepted that some of the data is limited. Whilst it purports to demonstrate that active management does not achieve better returns net of fees the report does not acknowledge that some funds do in fact deliver consistent outperformance. It does appear to be at odds with the wider policy objective of reducing deficits to encourage strategies that achieve average or worse performance rather than trying to capture above average performance.

The report urges an increased focus upon improved governance and this is to be welcomed. Academic analysis does, indeed, suggest that better governance ultimately leads to better performance but this is not directly measureable. Moreover, it is difficult to identify a linkage between fund size and governance or fund size and performance. However, there is evidence that a number of LGPS funds have generated higher absolute and risk-adjusted returns net of all fees on a consistent basis over the long term. This is not considered in the report. There is reluctant and belated recognition within the report that internally managed funds produce higher relative returns than all funds and that after costs are taken into account differential outperformance is even more substantial.

Notwithstanding these observations it is recognised that there are a whole range of varying performances amongst individual funds and that some LGPS funds are not achieving acceptable returns. However, the Hymans Report does not attempt to identify the impact of its conclusions on the best performing funds. A short-term solution should not be imposed upon the better funds by worsening their returns or increasing their costs in order to try and uplift the poorer performing. Instead, the challenge for the LGPS as a whole ought to be to seek to improve its investment performance and reduce its costs. Improving fund governance, encouraging greater collaboration between funds and sharing services and best practice are proven and cost-effective ways of achieving these aims.

The LGPS cannot afford to be complacent. It isn't. Even the Hymans Report accepts that the LGPS provides good value for money and achieves good returns relative to other investors. However, compulsion is not the answer. Imposing a model based upon less than solid evidence could potentially have unforeseen and unintended consequences over both the short and longer term.

HYMANS' ANALYSIS

Passive v active; internal v external

In paragraph 4.22 of their report Hymans stated that fee savings achievable from moving to passive management of listed assets would be £230m per annum if all funds moved. This £230m is derived from active management fees estimated to be £311.5m (equities £257m, bonds and cash £54.5m) but this estimate includes performance related fees which, by definition, are only payable if performance exceeds the appropriate benchmark. The logic of this is that if costs are reduced because of the switch so will performance returns. The

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greater the outperformance the greater the fee savings achieved. However, it is easy to show that in generating that level of performance the outperformance achieved would be almost as much as the savings identified. In other words, the analysis should exclude performance fees.

Hymans also estimate that turnover costs would be cut by £190m in 2012-13 if all LGPS equities (UK and overseas) were managed passively. However, this is not a saving that can be captured since lower transaction costs are embedded in the return achieved just as higher turnover costs are included in the returns produced by active managers.

When Hymans compare LGPS performance net of transaction costs they are doing so against an index that does not include such costs. Hymans' analysis does not include risk-adjusted returns. It already includes assets that are managed on a passive basis (some 44% of LGPS equities and bonds are said to be so managed) so these ought to be excluded.

According to data prepared by WM the risk adjusted return of the average LGPS fund versus benchmark over the ten years to March 2013 was over 0.35% for equities and a slight underperformance on fixed income.

Research prepared by State Street and Research Affiliates demonstrates that portfolio turnover in externally managed active accounts is higher than passive management but also clearly shows that internally managed, both within the LGPS and in the private sector, show markedly lower turnover rates than external funds.

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Transaction Costs

- Portfolio turnover is higher in **external** active management …

Portfolio turnover	Equities	Fixed Income
Passive		
Cap-weighted	4 – 12%	28%
Fundamental-weighted	9 – 25%	42%
Equal-weighted	23-36%	N/A
WM All Funds Universe		
Externally managed	46 – 95%	N/A
Internally managed	25 – 46%	N/A
WM LGPS Universe	42 – 64%	90%
Internally managed funds	13 – 20%	N/A

Sources: Research Affiliates, State Street Investment Analytics

Not surprisingly, higher turnover translates into higher transaction costs. However, it must be remembered that these are already reflected in performance data.

Transaction Costs

- … resulting in higher transaction costs …

Transaction costs	Equities	Fixed Income
Passive		
Cap-weighted	4 – 12bps	14bps
Fundamental-weighted	9 – 25 bps	21bps
Equal-weighted	23 – 36bps	N/A
WM All Funds Universe		
Externally managed	46 – 95bps	N/A
Internally managed	25 – 46 bps	N/A
WM LGPS Universe	42 – 64bps	45bps
Internally managed funds	13 – 20bps	N/A

Estimated annual transaction costs based on total transaction costs of 1% for Equities and 0.5% for Bonds

- …which are already reflected in performance data
- Transaction costs for active management in internally managed funds are on a par with passive management

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Transaction costs for active management in internally managed funds are on a par with those suffered in passive management and are lower still in LGPS internal funds. Overall, evidence supports the view that internal management is cheaper than external and cheaper than passive.

Investment Management Costs

- Active management is more expensive than passive …

	Active	Passive	Total
Equities	39bps	6pbs	24bps
Fixed Income	30bps	6bps	19bps
Property	77bps	-	77bps
Alternatives	171bps	-	171bps
Total	**62bps**	**6bps**	**42bps**

Source: Hymans Robertson, "LGPS Structure Analysis", December 2013

- …but internal active management is on a par with passive

	External Active	Internal Active	External Passive	Internal Passive	Fund-of Funds
Equities	48bps	7bps	6bps	5bps	-
Fixed Income	31bps	3bps	7bps	-	-
Property	75bps	26bps	-	-	126bps
Private Equity	165bps	30bps	-	-	247bps

Source: CEM presentation at NAPF Conference, May 2014

- An element of double-counting of costs which have already been deducted from performance – treat with caution

The Hymans report assumes that passive management can be applied successfully to both equities and bonds. It also assumes that there is only one approach to passive management. However, there are many investment options each of which has varying degrees of risk, performance and cost. The traditional form is known as market weighted and uses indices based upon the size of the underlying companies or the pools of debt. This approach tends to overweight sectors which are expensive or those that have issued more

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debt. Concerns around passive investment into bonds have been well documented for replication would result in major exposures to those issuers that are simply the most indebted in an index. This, somewhat perversely, adds to the risk of default. A more modern approach is known as “smart beta” but this also takes various forms. In broad terms these tend to have a bias towards value stocks or smaller companies which in turn leads to higher levels of turnover and, therefore, higher costs. There is also greater risk. Academic research supports the view that smart beta strategies do outperform traditional ones over the long-term but much of the data is simulated.

Internally Managed Funds

- Internal management is cheaper than external management …

Investment management costs	**Year Ended 31 March 2013**	**5 years ended 31 March 2013**
Externally managed funds	25bps	26bps
Internally managed funds	5bps	5bps
Total	**22bps**	**23bps**

Annualised costs of investment management
Reference: Estimated costs of passive management are 6 – 10bps

- … and all forms of passive management

Fees	**Cap-weighted**	**Fundamental**	**Equal-weighted**
Management fee	3 – 5bps	3 – 5bps	3 – 5bps
Licence Fee	-	5 – 6bps	-
CIV Costs	3 – 5bps	3 – 5bps	3 – 5bps
Total	**6 – 10bps**	**11 – 16bps**	**6 – 10bps**

Sources: State Street Global Advisers, Research Affiliates, London Councils, May 2014

- Avoids the issue of double-counting of costs prevalent in the Hymans/CEM data

One important consideration for LGPS funds to acknowledge is that adopting a passive approach results in exposure to all stocks in an index irrespective of the fundamental attributes of them which means that corporate governance and responsible investment concerns are much more difficult to manage.

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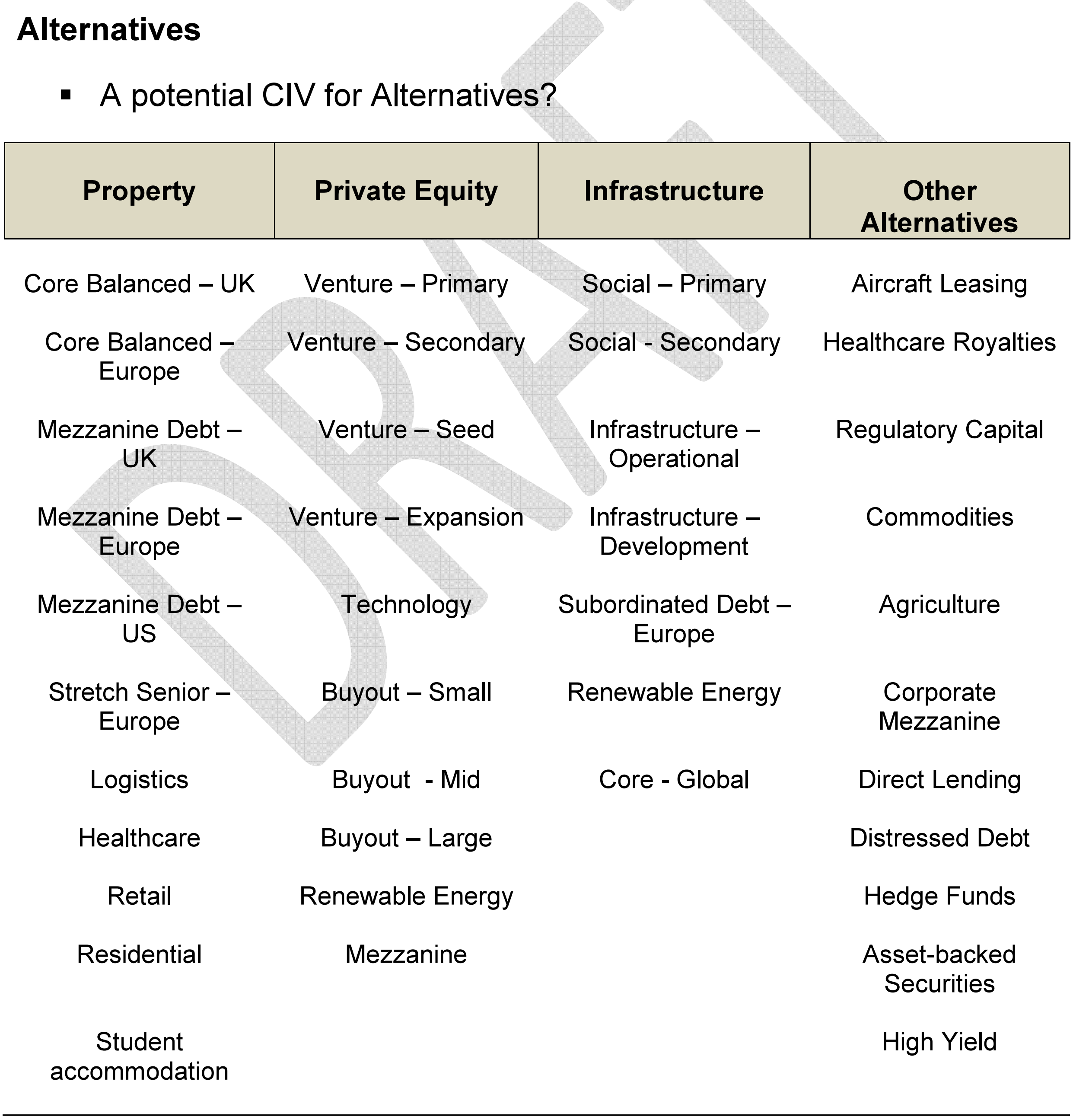
Alternatives

Hymans lay great emphasis on the disproportionate cost for the LGPS in investing in alternative assets (<10% assets, c40% of the cost). Hymans estimated that ending the use of "fund of funds" would cut £240m or 36% from all LGPS fee costs.

Once again the analysis on alternatives focused upon costs. It is undeniable that there is a layering of fees: however, that can be seen as the price for accessing best-in-class funds run by the best managers; gaining access to asset classes that would otherwise be inaccessible to most individual funds; garnering diversification benefits; purchasing the best due diligence research. There is a large dispersion of returns between funds and access to the best performing ones is a crucial performance factor. Given the nature of the underlying investments some degree of due diligence will need to be undertaken by somebody so at some level within whichever vehicle is used to access the asset class there will be additional cost.



Alternatives

- A potential CIV for Alternatives?

Property	Private Equity	Infrastructure	Other Alternatives
Core Balanced – UK	Venture – Primary	Social – Primary	Aircraft Leasing
Core Balanced – Europe	Venture – Secondary	Social - Secondary	Healthcare Royalties
Mezzanine Debt – UK	Venture – Seed	Infrastructure – Operational	Regulatory Capital
Mezzanine Debt – Europe	Venture – Expansion	Infrastructure – Development	Commodities
Mezzanine Debt – US	Technology	Subordinated Debt – Europe	Agriculture
Stretch Senior – Europe	Buyout – Small	Renewable Energy	Corporate Mezzanine
Logistics	Buyout - Mid	Core - Global	Direct Lending
Healthcare	Buyout – Large		Distressed Debt
Retail	Renewable Energy		Hedge Funds
Residential	Mezzanine		Asset-backed Securities
Student accommodation			High Yield

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There is an assumption within the report that one single vehicle could access all potential investment classes. This appears to be naïve given the widely dispersed attributes of the various categories that form the class and the specialist knowledge that whoever is conducting the research requires. Moreover, given capacity constraints in the underlying sectors there could well be diseconomies of scale as a result. Taken together it seems unlikely that these and similar constraints will actually lead to a significant fall in fees payable. According to Hymans there are £18bn of LGPS monies invested in this area which result in fees of 1.71% before performance fees. Hymans postulate that these could be reduced to 0.35%. This appears to be highly optimistic.

Whilst it is, of course, worthwhile exploring ways in which the management overhead could be mitigated, experience suggests that other than for private equity alternatives have not been particularly beneficial for funds on a net of fees return basis. It might be more pertinent to ask funds 'why have them' rather than how to gain access slightly less expensively.

MATTERS NOT FULLY CONSIDERED

Internal management

The Consultation document refers to "more use of better in-house investment management" but is treated as almost a tertiary objective. Indeed, the Hymans report gives the option little space. It is thought that some twenty funds conduct a degree of in-house management (often passive equity at low cost) even if just five were identified by Hymans as managing more than two-thirds of their assets internally. Whilst Hymans concede that these funds have done well compared to their peer group they argue that this is primarily due to lower cost. However, other evidence demonstrates that the longer term horizons adopted by internal teams and their lower risk profile also add to performance.

The Report has a section which places the proposals in the context of the legal position. It is clear from work done by the Local Government Association that the Local Government Act 1972 s101(1)(b) allows for investments to be managed by another administering authority already. Therefore, this gives other authorities access to existing in-house management teams so long as they are FCA registered (as this Authority is). In contrast, it appears that primary legislation would be required to establish CIVs.

This Authority, which is FCA registered, has successfully managed the South Yorkshire Passenger Transport Pension Fund on behalf of sister authorities for a number of years. This is proof that this model works. The option of utilising existing expertise is, therefore, clearly an attractive one and extension of the model ought to be pursued further.

Liability modelling and monitoring

Although this fact is briefly alluded to in the report it is the case that none of the 89 funds involved share the same identical liability profile. There might well be areas of overlap but given the very wide range of employers and employees in the Scheme it is not a surprise that this should be the case. Individual funds will have different levels of maturity and this will be reflected in the funds' individual asset allocation profiles.

The imposition of centrally determined CIVs will significantly diminish the ability of individual funds to manage their liability risk. Many funds are considering or have introduced some form of liability discount modelling which is triggered as market valuations change. More often than not these programmes are bespoke and specific to the fund in question. Given the need to manage deficits properly this is not an insignificant consideration.

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Responsible investment and governance

Although the report does recommend the retention of local accountability it gives no consideration to corporate governance policies and practices which are an intricate component part of the stewardship of fund assets. Indeed, it can be argued that by encouraging the introduction of large passively managed CIVs it will be weakened since it is far from clear at what level company engagement and proxy voting will operate. LGPS funds are highly aware of financial and reputational issues that are more likely to emerge through holding index positions in stocks with unacceptable governance models.

Tax

Because there is a 0.5% Stamp Duty imposed upon purchases of UK equities, research by Mercers suggests that the Treasury receive £40m per year more in tax under the present investment regime than it will if the move to passive management takes place. This figure is included in Hymans' transaction costs and is thought to be the biggest component. It is a real cash sum rather than a notional saving.

CONCLUSION

The Authority understands that the consultation applies to 89 funds and that it is not a typical administering authority. The Authority also acknowledges that, whilst the report concedes that LGPS funds offer better value for money in comparison with private sector funds with lower fees being achieved without detriment to returns, there are wide variations in performance across the Scheme. The Authority is concerned that the approach being mooted will penalise the better performing funds either by reducing their opportunity to capture investment returns or increase their costs. For some funds the proposals might be appropriate: for many they will not. The Government, or Shadow Advisory Board, should pursue the issue of education and training, for both elected members, employee representatives and officers, more vigorously.

Interestingly, in a special briefing note published in May, Hymans acknowledged that active management does have a role particularly for more complex and less liquid asset classes. It can also be worthwhile, they concede, in listed assets particularly in sectors or regions where there is evidence of an ability to consistently add value. Hymans also observed that passive compulsion would be very wrong for those funds that do benefit consistently from active management. Aon Hewitt has stated that there is a role for good active managers in all asset classes and not least in the area of alternative investments. Aon also state that there are well documented shortcomings in market capitalisation based passive management. Mercers are also concerned about the appropriateness of "naïve" passive management which, they state, is obviously inappropriate for bonds. Mercers also dismiss Hymans' assertion that not all active managers will be able to achieve returns higher than the market rate because that assumes that the whole market is managed by active managers. Mercers argue that other investors, such as non-profit maximising ones, allow scope for outperformance.

Given the above the Authority strongly believes that "comply or explain" is the best option for the consultation outcome because it provides the opportunity to retain the stronger elements of performance across the LGPS. Adopting that approach is not an easy option. It could be subject to regular review against a set of established and robust, but fund specific, objectives and the requirement to review being included in the fund's Statement of Investment Principles. It should also be accompanied by an increased focus on improved governance.

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Internal management not only demonstrably delivers improved investment returns but also lower costs. It also leads to better governance because the alignment between the interests of the management of the assets and the investment beliefs of those accountable for performance will be greater. As the table included in the response to Q1 shows, if the adoption of CIVs was imposed upon this Authority its annual costs would increase by some £2.5m and it would forego the benefits of active internal management which has yielded some £98m over the last ten years.

There is a risk that the consultation's focus on harvesting reasonably accessible and easy cost savings by reducing levels of active management fees (the legitimacy of some of the figures quoted notwithstanding) deflects attention away from the more pressing and important issue of tackling fund deficits. Improving net investment returns is, or course, worthwhile but such an improvement will only chip away at the size of the overall deficit: it will not solve it.

There is an urgent need to establish a consistent and realistic measurement basis for deficits across the LGPS. To that end all consulting actuaries should be urged to use common criteria when conducting actuarial valuations. This is as crucial an exercise as the one concentrating upon extracting consistency across cost data but has not attracted the attention it deserves. Similarly, the greater role of investment consultants, especially when advocating changes to benchmarks and asset classes or during manager searches, should be subject to further scrutiny.

The government should not be under any illusion that this consultation will, by itself, result in improving deficit levels. There is no magic solution. Deficits will only be repaired by achieving a combination of increased contributions, controlling costs, reviewing benefit levels and obtaining consistently good investment performance.

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LGPS CONSULTATION: OPPORTUNITIES FOR COLLABORATION, COST SAVINGS AND EFFICIENCIES

Q1

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

The purported savings quoted within the Hymans Robertson report are based upon data which is open to challenge. In endeavouring to keep the report simple it is understandable that Hymans have opted to try and simulate a single entity LGPS fund. However, in doing so they fail to recognise the positive performance experience of the better funds and distinguish sufficiently between external and internally managed funds. If taken without critical analysis there is a considerable risk that the better performing funds will lose some of their performance advantage and suffer increased costs at the same time. As can be seen from the following table this Authority would be one that would suffer on both criteria.

Asset Class	**Valuation as at 31 March14**	**Passive Fees***		**Actual Costs**	
Equities					
Asia Pacific	465,573,931	£460,932			
UK	1,158,274,508	£451,719			
Europe ex UK	591,779,372	£792,998			
US	698,729,452	£412,246			
Emerging Markets	310,624,815	£695,785			
Total Equities		**£2,813,680**			
Bonds					
UK	22,228,687	£18,449			
Emerging Markets	146,289,395	£365,723			
Index-Linked	581,648,722	£168,688			
		£552,860			
			Total **£3,366,540**	**Internal management costs** **£809,726**	**Extra Costs** **£2,556,814**
Corp bonds	341,542,439	£283,482		£345,143	**-£ 61,661**
					£2,495,153

*Using Hymans data

We have achieved 0.2% pa outperformance over 10 year period. Based on starting figure 10 years ago of £2.4bn we have added an extra £98m in value

Based upon this Fund's actual costs for the last financial year and comparing them against the Hymans' data for passive management costs a switch to CIVs as proposed would cost this Authority approximately an additional £2.5m per annum in fees. Moreover, the Fund would forego the outperformance premium achieved by the internal management team of roughly £98m over the last ten years.

For some funds, especially the weaker performing ones or the smaller ones, CIVs might be suitable but this should be subject to individual fund requirements. Internally managed passive portfolios might well prove to be a better alternative.

Hymans have not fully recognised the costs of establishing and managing a range of CIVs. There is a suspicion that transaction costs and frequency of trading have not been properly recognised. Because all LGPS funds are different and have different asset allocations and cash flows it should not be assumed that all purchases will be matched by sales.

Other potentially cheaper and more accountable alternatives to CIVs exist, such as delegated or collaborative arrangements under the LGA 1972 s101 provisions, which merit greater research.

External managers of established pooled investment vehicles might offer discounted fee structures for LGPS funds which might be a more beneficial option for funds to take.

Q2

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

Each administering authority has a duty to discharge its responsibilities to the best of its abilities and can only do so with reference to the specific liability and employer characteristics of its fund. Therefore, it is fundamental that asset allocation decisions remain at local level. This includes the ability to introduce liability modelling programmes.

Furthermore, administering authorities remain politically accountable to local taxpayers and to the employers within their fund.

Local authority funds are particularly sensitive to the need to encourage robust corporate governance standards in the companies in which they invest. Indeed, local authority funds are recognised as being leaders in ensuring sound stewardship of their funds' assets. The introduction of CIVs will weaken this linkage anyway: any further removal of control away from administering authorities would be detrimental.

Q3

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

On the limited information available it is not possible to reply to this question meaningfully. Whilst there are a number of potential managers and fund permutations available for consideration Hymans appear to have adopted a simplistic approach and have given greater priority to the drive for cost savings without regard to the ability of funds to access the best performing managers. It is unlikely that a single manager(s) will offer appropriate skill sets across all classes.

An illustration of the potential complexity of the CIVs required is included in the body of this response when a simple breakdown of a potential "alternatives" CIV is shown. There is no evidence submitted to support the idea that a collective approach in this area will enable funds to gain access to the best managers.

Recent research by the Cass Business School suggests that bigger is not always better in fund management. The research purports to show that a 1% increase in funds under management leads to a nine basis drop in alpha per year. The creation of very big CIVs, therefore, has to be treated with caution. This caveat should also be applied to passive funds since significant sized trades will run the risk of distorting underlying markets.

Q4

What type of common investment vehicle would offer the most beneficial structure? What governance arrangements should be established?

The Authority notes the discussion within the Hymans Report regarding the legal context surrounding the introduction of CIVs. The Authority is also aware of the work being undertaken by the London pension funds on creating and operating a possible CIV.

It would be prudent to wait for further work to be undertaken.

Please see comments made in response to Q1 and Q3.

Q5

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

The most appropriate option would be to allow funds to "comply or explain". This meets the recognised need to retain local accountability and would enable the better performing funds to continue to deliver results without compromising their performance or increase their costs. It would also require poorer performing funds to review their policy decisions and address and justify their governance procedures.

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Appendix C

APPENDIX: COLLABORATION OVER ALTERNATIVE INVESTMENTS

This Authority mainly invests in private equity and alternative funds directly and not via fund of funds. This avoids paying extra fees but does require access to a specialised internal manager resource. There are a small group of LGPS funds who have a similar resource pool so it would seem sensible to develop this further.

Why?

Firstly, the CIV envisaged in the Hymans report appears to be a “fund of funds” in disguise but one which somehow has lower costs! There is no explanation of how this low level of costs will be achieved other than through the use of scale and purchasing power. However, that assumption ignores the negative side of trying to invest large scale monies which by definition limits access to just the larger, less specialist funds. Moreover, scale by itself does not reduce the need for proper due diligence or for ongoing operational scrutiny: indeed, it probably requires more.

Secondly, the difficulty surrounding the setting up of a large CIV in this sector is well illustrated by the problems encountered by the Pensions Infrastructure Platform (PIP). Originally unveiled in November 2011 with a target of £2bn it announced its first fund in February 2014 with just £260m committed. Three out of the original ten signatory contributing funds have withdrawn due to conflicts over costs, structure and strategic aspirations. PIP was just a single sector fund focused on infrastructure and so should be less complex than the all-embracing one envisaged by Hymans.

Possible solution: collaboration

SYPA was one of five LGPS funds which collaborated together on an initiative known as “Investing for Growth”. Co-operation between the funds led to due diligence responsibilities being shared amongst them. Thirty three submissions from twenty eight managers were finally translated into £150m of investment into five funds run by three managers. A sixth pension fund later joined the group. The outcome was that appropriate institutional returns were obtained within acceptable risk parameters whilst at the same time enabling individual funds to allocate monies to the funds of their choice and promote good ESG principles. No additional overheads. No unusual costs.

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