Subject	**Benchmarking Investment Costs and Performance**	**Status**	For Publication
Report to	Local Pension Board	**Date**	28th April 2022
Report of	Director and Head of Investment Strategy		
Equality Impact Assessment	Not Required	Attached	No
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1 Purpose of the Report

1.1 To provide an update for the Board on the results of benchmarking work undertaken on the Authority's investment performance and costs.

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2 Recommendations

2.1 Members are recommended to:

a. Note and comment on the results of the investment benchmarking exercise.

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3 Link to Corporate Objectives

3.1 This report links to the delivery of the following corporate objectives:

Investment Returns

To maintain an investment strategy which delivers the best financial return, commensurate with appropriate levels of risk, to ensure that the Fund can meet both its immediate and long term liabilities.

Effective and Transparent Governance

To uphold effective governance showing prudence and propriety at all times.

4 Implications for the Corporate Risk Register

The actions outlined in this report relate to identified risks in relation to investment performance and the effectiveness of the pooling process.

5 Background and Options

5.1 As part of efforts to establish the success of the pooling process in improving both the cost efficiency and performance of the Local Government Pension Scheme (LGPS) the Government at the beginning of the process encouraged LGPS funds to participate in investment benchmarking exercises. SYPA along with most other LGPS funds and pools has for the last 7 years participated in a benchmarking exercise undertaken by CEM a global provider of such services. The particular advantages of this form of benchmarking are the provision of comparisons both with a universe of 35 similar LGPS funds involved in other pools but also with a group of 10 large global pension funds. This and the fact that the comparison examines not just cost but performance and the level of risk adjusted return provide significant added value to users.

5.2 By the nature of these exercises results are not necessarily available particularly quickly after the end of a reporting year and the results being commented on here relate to the year ended 31st March 2021.

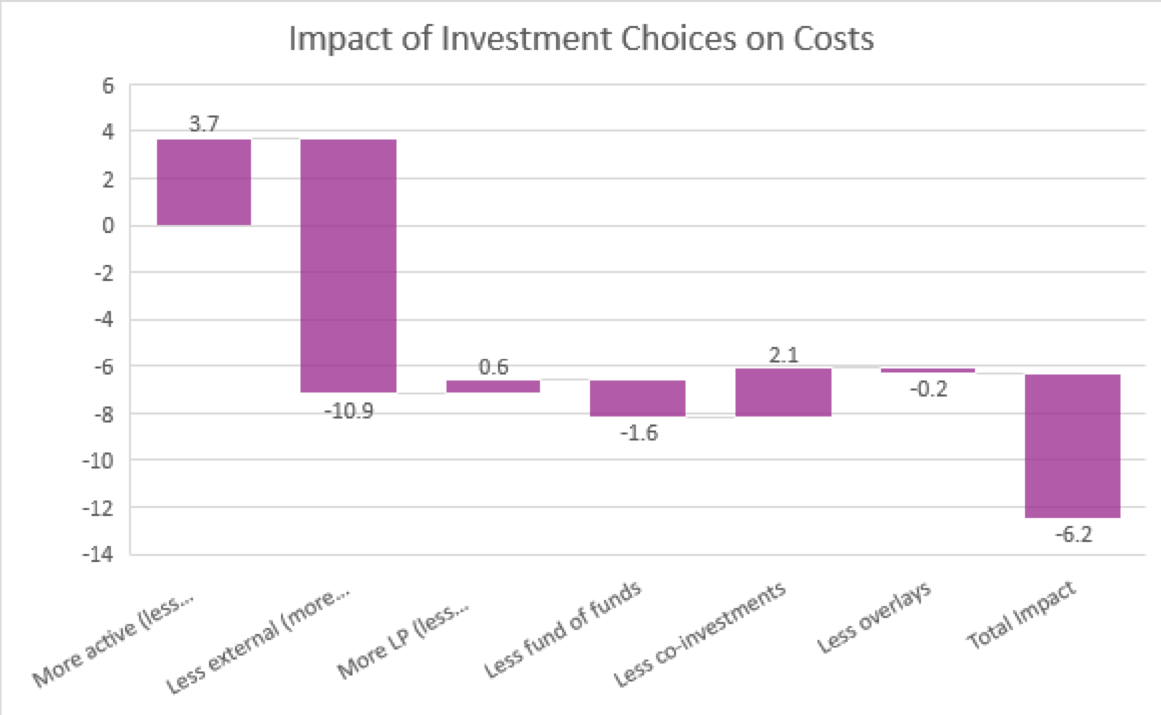
Cost Comparison

5.3 CEM make their cost comparisons using the absolute costs expressed in basis points (bps) relative to the assets being managed. 10 basis points = 0.1%. This allows the easy elimination of currency differences. Comparisons are made with a benchmark that represents the median of the peer group adjusted to reflect differences in asset mix to provide the fairest possible comparison. The table below shows the headline comparison. Please note that throughout the following analysis figures may not sum due to rounding.

	£000	**bps**
SYPA Cost	60,669	68.6
Benchmark Cost	60,332	68.2
Difference	**336**	**0.4**
This difference is explained by two factors		
	£000	bps
Implementation Style	-5,500	-6.2
Paying More for Similar Assets	5,837	6.6
Difference	**336**	**0.4**

5.4 What this tells us is that the positive differences in cost are accounted for by a number of choices made by the Authority about how it invests money, which largely flow from the Authority's investment beliefs. These can be seen in the graph below, the key takeaways from which are:

- The additional cost of active management is substantially outweighed by the lower costs of internal management.
- Using fewer fund of funds in the alternatives portfolio largely offsets the difficulty of making more co-investments due to both the resources available and the scale of the individual investments within the alternatives portfolio prior to pooling.



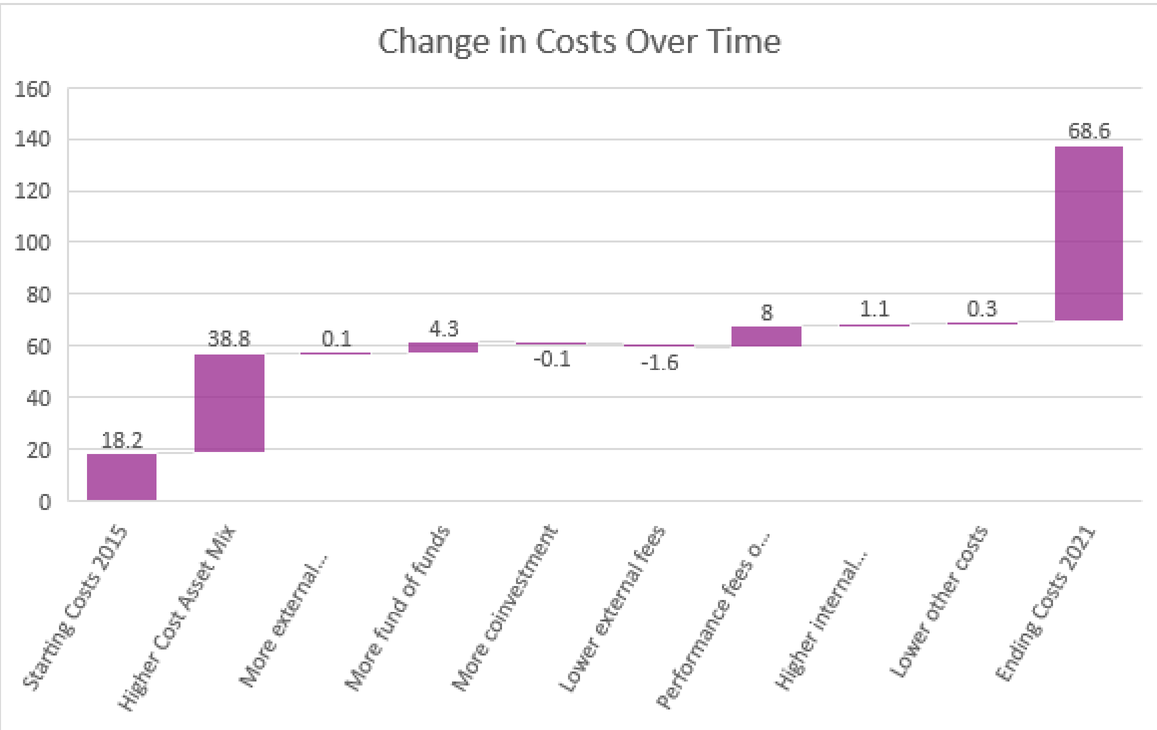
5.5 In essence this reinforces what was said when SYPA embarked on the pooling process which is that internal management maintains lower costs providing the opportunity to use the available budget to do a bit more in higher cost areas such as alternatives. This is borne out when the choices made by SYPA are compared both with the LGPS Group and the global group where:

- SYPA invests very materially less through expensive fund of funds than the LGPS group and significantly less than the global group.
- SYPA invests nothing passively compared to over 23% in the global group and 20% in the LGPS group.
- SYPA invests very materially less through external managers than either comparator group. This is significant as the comparators include some large North American funds which have internal capabilities.

5.6 If we look at the areas of cost comparison which are concerned with the price paid as illustrated in the chart below the following are the key takeaways:

- The costs of the pooled products for listed assets are below the benchmark reflecting the internal management approach. Better conclusions will be able to be drawn on this in future when products like the MAC fund are included in the comparison.
- Direct holding of property is a less expensive way of holding the asset class.
- The legacy alternatives portfolio may be higher cost because the scale of individual investments was smaller.
- The pooled alternatives costs are distorted by the fact that fees are paid on commitments but the comparison involves actual fees measured against invested cash so fees may appear overstated until investments are fully drawn.
- The lower costs of custody etc reflect a residual in house operating model which is in need of review given the fact we no longer run money directly.

5.7 It is possible to look at the way in which costs have moved over the 7-year period since we started participating in the CEM survey. This is illustrated in the chart below



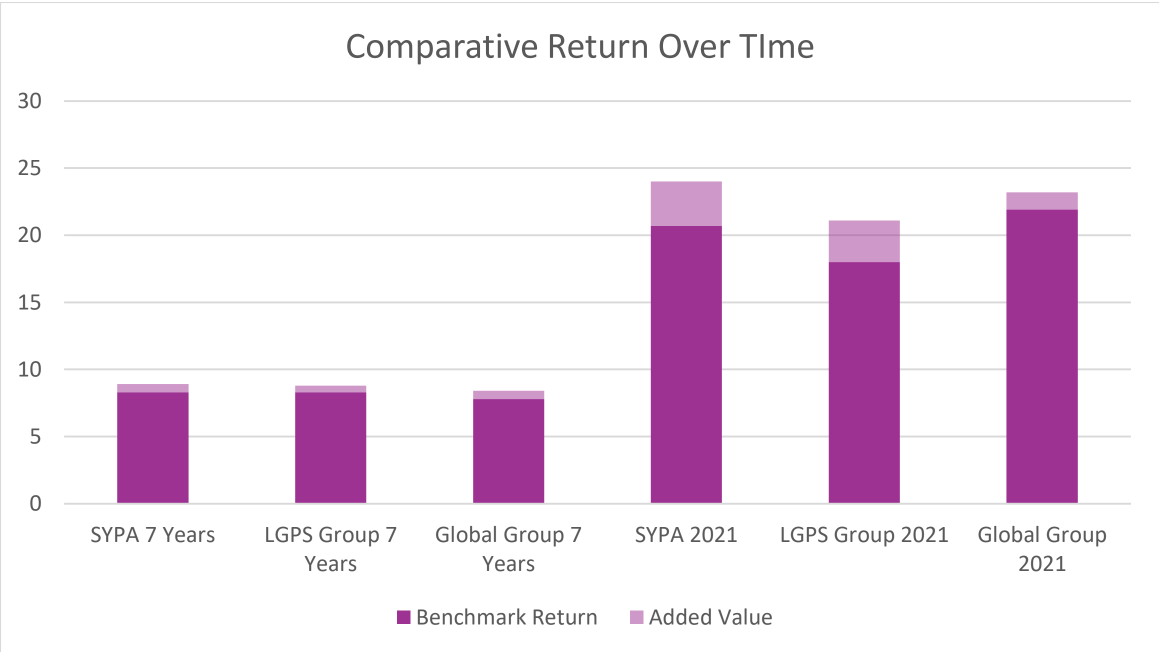
5.8 This does represent a very substantial increase in costs although the major driver is the strategic shift to invest a greater proportion of the fund in alternatives including infrastructure rather than in traditional listed assets, with alternative assets growing by from 15% to 26% of the Fund in the period. The impact of this on costs in isolation was always known to be negative. On the other hand the increase in performance fees paid on the alternatives portfolio should be regarded as a positive as it indicates success by managers in achieving their performance targets. Similarly, it was known that delivering internal management through the Pool was always likely to be more expensive than maintaining the previous, probably unsustainable in house business model, and at 1.1 bps this is not material in the overall scheme of things particularly when considered against the increased resilience provided for this cost.

Performance Comparison

5.9 While costs are important they need to be seen in the context of the performance that has been delivered in return for the costs invested. CEM break performance down into two components:

- Benchmark return: The return from strategic asset allocation decisions if implemented passively. These decisions are typically made in SYPA by the Authority.
- Value added: A function of active management decisions, including tactical asset allocation, manager selection, stock selection, etc. These 'implementation' decisions tend to be made by management. In simple mathematics this is the total return minus the benchmark return.

5.10 Looked at for 2021 and the whole of the 7 year period then the comparison between SYPA and both the LGPS and Global comparator groups is shown below:



5.11 The key message in this is that over the longer term SYPA has delivered more added value than the LGPS average although less in the last year, likely due to the fact that our equity holdings are a smaller proportion of the Fund than average and they are not operated to achieve the higher performance targets of many external managers. The comparison with the global group over both periods is also favourable. The particular contributors to value added were listed equities and private equity, with index linked bonds and property making relatively small negative contributions. Over the 7 years CEM estimate that the added value delivered has added £411m to the value of the Fund which is a material amount. The % value added is almost twice the LGPS average and more than twice the global average, again representing material outperformance.

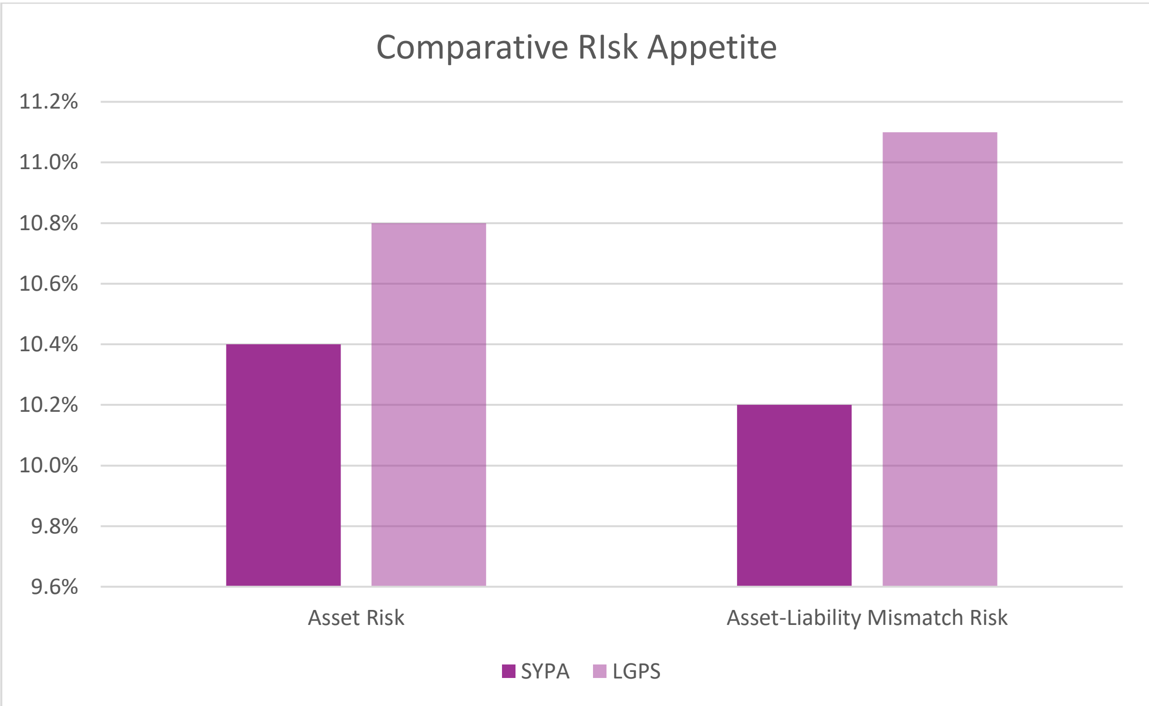
5.12 Return is a function of strategic asset allocation and over the 7 year period as part of the conscious approach to reduce exposure to market volatility and to seek different sources of return the Fund has moved out of equities where in 2021 we held 45% of the Fund compared to the LGPS average of 53% with 31% in alternatives (including property) compared to an average of 28% and with more assets held in bonds than the average (25% compared to 19%), although with a different and higher return focussed mix than the average. This would seem to be paying dividends in terms of the overall picture of consistency of return.

5.13 The strategic asset allocation broadly reflects the Fund's appetite for risk which is described in our investment beliefs as "moderate". Risk can be looked at in two ways

- Asset Risk – A higher asset risk is indicative of a higher weighting to more volatile assets and/or more concentration in the portfolio (and vice versa), and
- Asset – Liability mismatch risk- A lower asset-liability mismatch risk means the fund is closer to a "fully matched" position. A higher asset-liability mismatch risk is indicative of a willingness to take more risk relative to liabilities.

5.14 In general terms the Fund's strategy in recent years has been to reduce risk exposure as it has come closer to and/or achieved a fully funded position, while recognising that risk has to be taken in order to achieve the returns required to meet future liabilities. The chart below shows how the two metrics described above have moved over time.

5.15 What this shows is that the level of risk being taken has moved down showing that the moves in the strategic asset allocation have achieved their intended purpose. However, it is also worth examining whether we are taking more or less risk than our peer group in order to achieve our return which in the longer term is somewhat better than the LGPS average. The position for 2021 is illustrated below



5.16 Thus SYPA would based on this analysis seem to be taking materially less risk than the average across LGPS while achieving comparable short term returns and superior longer term returns. This would seem to support the very long term consistent approach to the investment strategy which has been based on “slow and steady wins the race”, rather than aiming to achieve top quartile returns on every asset class every year. Compared to other LGPS funds this puts us in the better funded less risk group of funds with above median funding (using the Scheme Advisory Board standard basis) combined with lower than median risk. This is clearly a desirable position and one that we will seek to maintain.

5.17 CEM’s overall conclusion is that the Fund is delivering positive value add at low (tending towards median) cost. This is clearly where we would want to be but we do need to keep an eye on whether the continuing changes to the asset mix are delivering both the required performance and risk at reasonable cost.

6 Implications

6.1 The proposals outlined in this report have the following implications:

Financial	None directly
Human Resources	None
ICT	None
Legal	None
Procurement	None

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Background Papers	
Document	**Place of Inspection**
CEM Benchmarking Report	Oakwell House