

HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Pension Fund Panel
Date:	13 June 2014
Title:	Government consultation on Opportunities for Collaboration, Cost Savings and Efficiencies
Reference:	5899
Report From:	Director of Corporate Resources – Corporate Services

Contact name: Ian Howell

Tel: 01962 847540

Email: ian.howell@hants.gov.uk

1. Executive Summary

- 1.1. This report suggests a response to the consultation paper published by the Government in May 2014 on the opportunities for collaboration, costs savings and efficiencies in the Local Government Pension Scheme (LGPS).
- 1.2. The deadline for responses to the consultation is 11 July 2014.

2. Background

- 2.1. In recent months, the Government has been considering the responses to its call for evidence on the future structure of the LGPS, including the merger of funds. As part of that process, it engaged Hymans Robertson to report on three options for reform:
 - establishing one common investment vehicle for all funds
 - creating five to ten common investment vehicles for fund assets
 - merging the existing structure into five to ten funds.
- 2.2. Hymans Robertson estimated that savings of £420m could be achieved nationally if the LGPS's investments in equities and bonds were managed in a single common investment vehicle and were held in passively managed funds. A further £240m could be saved if a common investment vehicle was used for alternative investments, including property, to replace existing investments held in 'fund of funds' arrangements.
- 2.3. The Government's consultation paper is attached as Appendix 1.

3. Merging LGPS funds

- 3.1. The Government has decided not to consult further on the option of merging LGPS funds at this time. Administering authorities such as the County Council will continue to be responsible for determining the Pension Fund's investment strategy and its allocation between asset classes.
- 3.2. The Government took into account the cost and disruption of mergers, the timescale that would be required and the loss of local accountability.

4. Common investment vehicles

- 4.1. The Government considers there is a strong case now, however, for achieving economies of scale for the LGPS through the use of common investment vehicles and, secondly, through the use of passive fund management.
- 4.2. Under the common investment vehicle model, all investment assets for the LGPS would be held in one, or more, centralised arrangement. The vehicle would appoint managers for each asset class and investment style. LGPS funds, such as Hampshire, would decide how much they want to allocate to each asset class and would invest in the common investment vehicle's pools of assets, either on a unitised basis (similar to a unit trust) or on a share price basis. Hampshire would no longer appoint its own fund managers.
- 4.3. Based on Hymans Robertson's work, the Government believes that savings from this model would be achieved from:
 - investing equities and bonds via a common investment vehicle using passive fund management, with the resultant savings taking one to two years to recover the costs of transition
 - eliminating the use of 'fund of funds' arrangements for alternative investments which have high fee structures, although this would take up to 10 years to achieve in full as existing contracts run down
 - lower procurement costs through use by the common investment vehicle of procurement frameworks
 - lower transaction costs by cross-matching investments and redemptions within the common investment vehicle
 - lower actuarial and custodial costs.
- 4.4. The Government argues that using a common investment vehicle would improve the transparency of LGPS funds' investments, including making clear the effectiveness or otherwise of each fund's asset allocation decisions. A common investment vehicle for alternative investments could also make it easier to invest in infrastructure.
- 4.5. The Government believes that these proposals would be most effective if adopted by all LGPS funds in England, through a single common investment vehicle (ie, with separate pools for listed assets and alternative investments). The savings would be lower if more than one common investment vehicle was established (such as on a regional or local basis).

- 4.6. Concerns about the risk of concentrating assets in one pool, reduced diversification, and the capacity of the fund management industry to service such large common investment vehicles are downplayed by the Government, particularly if its preferred outcome of passive fund management is adopted.

5. Passive fund management

- 5.1. Hymans Robertson compared the returns from equities and bonds for all LGPS funds over the 10 years to March 2013, net of fund management fees, with benchmark indices. This showed no clear evidence that active fund management provided any additional returns for the LGPS as a whole. They concluded that, on average, equities and bonds could have been managed passively without affecting the LGPS funds' overall performance.
- 5.2. Hymans Robertson calculated that savings in management fees of £230m per annum could be achieved from switching to passive fund management. They also estimated that £190m per annum would be saved from lower transaction costs
- 5.3. There would be costs of transition incurred in switching from active to passive management, which Hymans Robertson estimate to be a one-off cost of £190m. Net savings would begin to accrue within two years of moving to passive management.
- 5.4. The Government has accepted this analysis and wishes to explore how LGPS funds could be required to make greater use of passive management.

6. The Government consultation questions

- 6.1. The Government has asked five questions in the consultation paper:
 - 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.
 - Q2. Do you agree with the proposal to keep decisions about asset allocation with the local fund authorities?
 - 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?
 - Q4. What type of common investment vehicle do you believe would offer the most beneficial structure? What governance arrangements should be established?
 - Q5. In light of the evidence on the relative costs and benefits of active and passive management, including Hymans Robertson's evidence on aggregate performance, which of the following options offers best value for taxpayers, Scheme members and employers?

- funds could be required to move all listed assets into passive management, in order to maximise the savings achieved by the Scheme
- funds could be required to invest a specified percentage of their listed assets passively, or to progressively increase their passive investments
- fund authorities could be required to manage listed assets passively on a “comply or explain” basis
- funds could simply be expected to consider the benefits of passively managed listed assets, in the light of the evidence set out in this paper and the Hymans Robertson report.

7. Comments on the Government’s consultation questions and suggestions for a response

7.1. The following commentary on the proposals is framed around the Government’s consultation questions.

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.

- 7.2. Hampshire Pension Fund is large enough at £4.5 billion to achieve competitive management fee rates for its actively managed equities and bonds portfolios and for its passively managed portfolios. There seems to be an assumption – but no evidence – that the fund managers will offer lower fee rates for very large portfolios, but there may be a threshold for fees below which the business would not be economic for fund management firms.
- 7.3. The Government has placed undue focus on the single issue of management fees. Controlling and minimising these fees is important but the key consideration should be the level of investment returns net of management fees.
- 7.4. If the Government forces all LGPS funds to adopt passive management for equities and bonds, there seems to be little point in creating a common investment vehicle with an added layer of costs and fees. Instead a single contract could be established with a passive fund manager which LGPS funds could access.
- 7.5. If active management is still permitted by the Government, but it has to be sourced via a common investment vehicle, the extent of choice for LGPS funds over the types of fund management available would be reduced. It would be better to continue to allow individual LGPS funds to use the market for fund management services to find the most suitable managers for their circumstances than to impose a centrally planned arrangement. With that freedom to decide their own investment arrangements, individual LGPS funds with similar actively managed portfolios could group together for procurement purposes to increase their buying power.

- 7.6. It does not seem to be an appropriate role for central Government to dictate to individual LGPS funds how they should invest, particularly as the Government has no direct financial, legal or fiduciary interest in the outcome.
- 7.7. Hampshire has a significant alternative investments portfolio invested in private equity funds, hedge funds, infrastructure and other funds. It does not invest in any 'fund of funds' arrangements. All its alternative investments are direct holdings in the underlying funds.
- 7.8. Similarly, Hampshire's UK property portfolio is invested directly in individual properties, with the minor exception of the small allocations to specialist funds such as student accommodation.
- 7.9. There would be no benefit for Hampshire, therefore, from using a common investment vehicle for alternative investments and property. There would probably be a reduction in choice and less flexibility compared with the current arrangements for Hampshire to select the alternative investments to meet its needs. This reflects Hampshire's size as one of the top ten largest LGPS funds.
- 7.10. The common investment vehicle approach may be appropriate for some of the smaller LGPS funds who are not able to invest directly in these areas. In that case, it would be more sensible to encourage individual LGPS funds to agree collaborative arrangements amongst themselves to meet their needs than for the Government to impose a common investment vehicle on all LGPS funds.
- 7.11. Hampshire does not manage any of its investments in-house. Some LGPS funds do, presumably on the grounds of low costs and efficiency. It is interesting that the Government's proposals for common investment vehicles would apparently sweep away these arrangements. It would be a matter of concern for Hampshire, however, if the common investment vehicle decided to attempt to manage assets in-house itself.

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

- 7.12. This is a sensible decision by the Government, because of the cost and disruption of mergers and the loss of local accountability. Individual LGPS funds, such as Hampshire, should continue to be responsible for the investment of their funds.

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?

- 7.13. As outlined in the answer to question Q1, it would be sensible to leave the establishment of common investment vehicles to local authorities who decide to collaborate.
- 7.14. If the Government decides to impose a common investment vehicle model, there would be advantages in having only one organisation providing a national common investment vehicle arrangement.

- 7.15. The South East 7 group of local authorities have been discussing whether there is scope for increased collaboration on investment matters between the five LGPS funds in the SE7 area: West Sussex, East Sussex, Surrey, Kent and Hampshire. Officers from Hampshire have attended meetings with the other SE7 authorities. The position will continue to be monitored in the light of the Government's consultation paper. Local or regional collaboration may have advantages but, in terms of collaboration on the procurement of fund management services, it may be necessary to look to a wider range of LGPS funds across the country to find similarity in the investment services required. Jointly arranged procurement does not need to be organised solely between local neighbours.
- 7.16. If the Government forces LGPS funds to use passive management, it is questionable whether a common investment vehicle is necessary. A single central contract could be set up with a passive fund manager which allowed individual LGPS funds to draw down the passive funds for the asset classes they require for their investment strategies.
- 7.17. The asset classes represented in the common investment vehicle should cover the full range of asset classes currently used by LGPS funds. As indicated in the response to Q1, it is likely that if active management is still permitted it would be difficult to replicate the range of asset classes and mandates used by LGPS funds. In Hampshire's case, the current investment strategy would require the following asset classes for equities and bonds:
- Global equities – high performance target (benchmark plus 3% per annum)
 - UK equities – lower performance target (benchmark plus 1.25% per annum)
 - Global bonds – benchmark plus 1.5% per annum
 - UK index linked bonds – currently managed on a passive basis
- 7.18. In addition, Hampshire currently has a Tactical Asset Allocation portfolio which can be invested in a range of up to 35 passively managed equities and bonds portfolios. This includes regional equity portfolios, including some with the currency exposure partly or wholly hedged back to Sterling.
- 7.19. For alternative investments and property, it is difficult to see how a common investment vehicle could offer the range and flexibility of Hampshire's direct investments in a diversified range of private equity funds (of different vintages), hedge funds, infrastructure and other funds, and individual properties, all based on the advice from Aberdeen.
- Q4. What type of common investment vehicle do you believe would offer the most beneficial structure? What governance arrangements should be established?**
- 7.20. As outlined in the comments on the previous questions, it would be better if the Government allows individual LGPS funds to decide whether to enter into collaborative arrangements. The structure and governance arrangements would then flow from the nature of those local arrangements.

7.21. If a centralised common investment vehicle is imposed by the Government, it is essential that it is arranged efficiently and does not replicate the additional layer of fees attributed to 'fund of funds' arrangements. It would need to be tax efficient and provide the appropriate level of regulatory safeguards. But, beyond that, it requires the Government to set out in much more detail how they envisage the common investment vehicle would operate.

7.22. As the administering authority responsible for the investment of the Pension Fund, the County Council would not feel comfortable that decisions on the appointment (and termination) of fund managers would be transferred to a common investment vehicle, effectively a Government quango. As the common investment vehicle would be taking key decisions on the Pension Fund's investments, the County Council should be represented on the governing body of the common investment vehicle.

7.23. It would be inappropriate for the common investment vehicle to be influenced by nominees (for example, from the Scheme Advisory Board) with no statutory responsibility for the investment of LGPS funds or financial interest in the outcome – unlike Hampshire County Council and the employers and other stakeholders in Hampshire.

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

- **funds could be required to move all listed assets into passive management, in order to maximise the savings achieved by the Scheme**
- **funds could be required to invest a specified percentage of their listed assets passively, or to progressively increase their passive investments**
- **fund authorities could be required to manage listed assets passively on a "comply or explain" basis**
- **funds could simply be expected to consider the benefits of passively managed listed assets, in the light of the evidence set out in this paper and the Hymans Robertson report.**

7.24. The following paragraphs provide a commentary on the advantages and disadvantages of active and passive fund management, in the context of the Government's consultation questions. The Panel's views are requested on the responses to be made to the Government on Question Q5.

7.25. Passive fund management is one of a wide range of investment tools available to pension funds to achieve the returns they require. LGPS funds should be able to take their own decisions on whether or not to use passive or active management, along with all the other decisions required when investing pension fund assets. It would not be appropriate for central Government to impose its views on, for example, passive management on LGPS funds.

- 7.26. The Panel has used active fund management since the investment management of the Hampshire Pension Fund was first outsourced in the mid 1980s. During the full review of the investment strategy in 2006, which led to the current structure of specialist fund managers, the Panel considered whether passive management should be used for parts of the investment strategy. The Panel decided that there was little scope for achieving significant additional returns from active management of UK Index Linked Bonds and these bonds (over 20% of the Pension Fund) have been managed passively since 2007.
- 7.27. The option of managing passively the 'lower risk' portfolio of UK equities was also considered in 2006 but the Panel decided to appoint Schroders as active managers of the UK equities portfolio with an outperformance target of +1.25% per annum. There is an argument that managers of low risk portfolios charge higher fees for effectively 'hugging' the index. Ironically or coincidentally, Schroders are currently the Pension Fund's most successful manager since 2007, in terms of outperforming their benchmark index.
- 7.28. Passive fund management is sometimes characterised as being low risk. But the indices tracked by passive fund managers can involve degrees of risk. By reflecting past market capitalisations, equities indices represent mature companies and industries that have performed well in the past and will under-represent newer and growing companies. Active fund managers are able to select such companies and that can provide the opportunity for them to outperform the market. Corporate bonds indices reflect the companies with the largest debts. The most highly indebted companies may not be the best companies in which to invest.
- 7.29. Information about the returns from the Pension Fund's active managers since January 2007 is included in Appendix 2.
- 7.30. The use of active or passive fund management has always been an option for the Panel to consider. It does not require the Government to impose the use of passive management or specify the percentage of the Fund to that must be invested passively. The Pension Fund's fiduciary duty already covers its responsibilities for investment decisions. The decision on active or passive fund management should be left to the discretion of individual LGPS funds, taking into account all the available evidence. The Pension Fund has always be willing and able to explain the results.
- 7.31. In assessing the level of employers' contributions, the Fund actuary Aon Hewitt have not assumed that the Pension Fund's use of active fund management will provide an additional return compared with passive management. If the Pension Fund switches to passive management, higher levels of employers' contributions would not be immediately required.
- 7.32. Aon Hewitt may need to refine the investment strategy for the Pension Fund, to be reported to the Panel's next meeting on 11 July 2014, if a decision was taken to switch from active to passive management.
- 7.33. There will always be winners and losers amongst active fund managers. Including a large number of pension funds in a research database will increase the likelihood that as many losers as winners will be included in the

research. Averaged active management returns are likely to be similar to, or lower than, market returns provided by passive management. Hymans Robertson's research looked at the average returns from the 89 LGPS funds and, on those grounds it is probably not surprisingly that they could find no evidence to justify active management. It is potentially very dangerous for the Government to base such a fundamental decision on one study.

- 7.34. There are some LGPS funds which have performed consistently well relative to their peers, according to Hymans Robertson. Efforts should be focused on helping all funds to improve their performance, instead of dragging the better funds down to the average.
- 7.35. Some active managers have argued that the most successful active managers are those that are managing portfolios with high performance targets. They are less constrained by their benchmarks and are more likely to take independent decisions that pay off. Managers with lower targets are too heavily influenced by their benchmark indices and tend to underperform as they do not have to take positive active decisions. This implies that if a decision is taken to use active fund management, the managers should be given sufficient scope within their mandates to be truly active.
- 7.36. The savings in management fees from switching from active to passive management has been calculated by Hymans Robertson to be £230m per annum or 0.15% of the value of the LGPS's listed securities. Whilst £230m is a significant figure, active fund management would only have to outperform by 0.15% per annum for the LGPS to be better off with active management. At the level of individual LGPS funds, a relatively small outperformance of 0.15% per annum is certainly feasible for well managed LGPS funds.
- 7.37. For Hampshire, switching to passive management now would mean terminating the four managers that have been successful for the Pension Fund since January 2007. But it would also remove the risk of having managers in the future that significantly underperform.
- 7.38. In terms of the responses to the Government's Question Q5 on the use of passive management, the Panel's previous policy of using active fund management would suggest that the response could argue that passive management should not be forced on LGPS funds. LGPS funds should retain their existing discretion to use either active or passive fund management based on their investment strategies. All LGPS funds should be happy to explain the rationale for their investment decisions.
- 7.39. Separately, as part of the review of the investment strategy to be considered at the Panel's next meeting on 11 July 2014, the Panel will have the opportunity to look again at advantages and disadvantages of using passive fund management in the light of the evidence earlier in this section. That should continue to be an option available to the Pension Fund within an overall policy of local discretion.

8. Conclusion

- 8.1. The deadline for responses to the Government's consultation is 11 July 2014. A response will be prepared based on this report and taking into account the Panel's comments and views including those on question Q5. The final draft response can then be agreed before despatch with the Chairman of the Panel.

9. Recommendation

- 9.1. That a response to the Government's consultation be drafted by the officers, based on this report and taking into account the Panel's views, to be agreed by the Chairman of the Panel prior to despatch.

CORPORATE OR LEGAL INFORMATION:**Links to the Corporate Strategy**

Hampshire safer and more secure for all:	yes/no
Corporate Business plan link number (if appropriate):	
Maximising well-being:	yes/no
Corporate Business plan link number (if appropriate):	
Enhancing our quality of place:	yes/no
Corporate Business plan link number (if appropriate):	
OR	
This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision because actions are required on a response to the Government's consultation on investment arrangements for the Local Government Pension Scheme.	

Other Significant Links

Links to previous Member decisions:		
<u>Title</u>	<u>Reference</u>	<u>Date</u>
Direct links to specific legislation or Government Directives		
<u>Title</u>	<u>Date</u>	

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

<u>Document</u>	<u>Location</u>
None	

IMPACT ASSESSMENTS:

1. Equalities Impact Assessment:

- 1.1. Equality objectives are not considered to be adversely affected by the proposals in this report.

2. Impact on Crime and Disorder:

- 2.1. The proposals in this report are not considered to have any direct impact on the prevention of crime.

3. Climate Change:

- a) How does what is being proposed impact on our carbon footprint / energy consumption?
No specific impact.
- b) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?
No specific impact.