Appendix 'A'

Consultation on Opportunities for Collaboration, Cost Savings and Efficiencies within the Local Government Pension Scheme

RESPONSES FROM LANCASHIRE COUNTY PENSION FUND

The Lancashire County Pension Fund is one of the largest funds within LGPS providing a means of pension saving for over 150,000 members from 270 employers and managing approximately £5.2bn of assets, The Fund welcomes the opportunity to respond to the Government's proposals for collaboration, cost saving and efficiency within LGPS.

Before turning to address the specific questions asked we would begin by expressing our disappointment with the paucity of ambition that lies at the heart of the proposals set out in the consultation document. The central proposals made by the Government look to "dumb down" to the average rather than seek to drive up performance across LGPS to the level of the best. If this were to be the result of this exercise it would be an enormous wasted opportunity for the LGPS as a whole.

There also appears to be a significant contradiction in tone between the text of the document which appears to have already arrived at a mandated solution and that of the questions which are somewhat more open.

In the response to the Government's questions that follows we have built on the following central beliefs:

- The Local Government Pension Scheme is a local scheme operating within a national framework of rules, rather than a national pool of assets;
- The individual funds within the scheme and their administering authorities must be accountable locally to the stakeholders in each fund, including:
    - local taxpayers whose taxes and services are impacted by the cost of pension deficits;
    - the various employers whose contributions are impacted; and most importantly,
    - scheme members whose current or future pensions are dependent on the assets held within the Fund
- That the interests of taxpayers locally and nationally will be best served by the delivery of effective strategies to eliminate the deficit within *individual* funds;
- That addressing funds' liabilities is as important as addressing the asset side of the balance sheet; and
- That effective, professional, investment governance is likely to be a much greater contributor to fund performance than a pure focus on fees.

We now address the specific questions asked in the consultation document.

Question 1

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

It is likely, although not certain, to be the case that by pooling assets it will be possible to reduce fees in relation to certain asset classes.

We have reservations about the relevance of the question, however; and we believe that it is disingenuous to attribute savings entirely to effect of pooling assets.

What is important is not the level of fees themselves but the level of investment return achieved after the payment of fees as well as the role that investment assets and the returns achieved on them play in matching a pension fund's liabilities and reducing current funding deficits.

Whilst reduced fee levels can of course help to improve investment returns, an investment strategy entirely predicated on fee reduction is unlikely to produce the combination of risk/return characteristics that a LGPF needs in order to safely address its funding deficit and provide an effective approach to liability management.

We also have concerns that Hymans Robertson were not asked to assess the increase in correlation between different LGPS asset pools that would arise from a move to a single passive strategy based around a single CIV. The suggested approach is likely to result in higher correlation between individual funds' performance than is currently the case and hence an increase in systemic risk for LGPS as a whole.

The scale of LGPS assets means that in down markets and as a result of so called "black swan" events, the likelihood and expected size of any systemic LGPS failure (and the potential for the need for central government 'bail-out', calling on the implicit Treasury Guarantee which has never yet been tested) is likely to be increased.

Addressing the question in relation to listed investments:

Fee savings from combining assets that are already passively managed will be relatively small as fees are already extremely low. An existing passive mandate, depending on size, is likely to attract a fee of 0.07% or less, whilst a combined mandate might reduce those fees to 0.03% or less.

Even if that level of saving were considered worthwhile due to the scale of assets under consideration, further savings would be likely to be available by transferring the mechanism of exposure from physical investment in the underlying assets to a synthetic (derivative-based) approach, where there is evidence to suggest that the same exposure can be generated (and the potential for tracking error reduced) for less than 0.01%; possibly up to a further 50% additional savings. Whilst the exact level of savings can be debated, we are surprised that this latter option was not even mentioned by Hymans Robertson in their report.

Another issue which has not been addressed is the systemic risk associated with providing such a large proportion of the LGPS assets to one single fund manager (or indeed the potential impact on said fund manager at some future date should the mandate be moved). The concerns surrounding this in the event of a failure of a fund manager in Britain should be self evident. Indeed the potential impact on the financial services industry, which is regarded as a significant British success story, of moving wholesale from active to passive management appears to have been ignored in the consultation document.

An alternative source of cost savings could come from combining assets that are currently actively managed (and leaving them actively managed) such that each active fund manager employed within the LGPS charges the lowest rate available. It depends on the manager in question, but (and assuming that such a manager has the capacity to accept further assets whilst maintaining the expectation of differentiated performance) we estimate that savings of 0.2% - 0.3% would be able to be achieved by smaller LGPS funds.

It is important to note that the potential for fee savings quoted in the Hymans Robertson report assume a transfer of all actively managed assets into much lower cost passive strategies.

The majority of the savings quoted in the Hymans Robertson report do not actually arise from the benefits of pooling assets, therefore, but from the decision to change asset allocation from active to passive management. This itself is an investment decision which, if centrally mandated (whether directly or via a 'comply-or-explain' approach), would appear to contradict the principles of leaving asset allocation decisions with local authorities as discussed in Question 2.

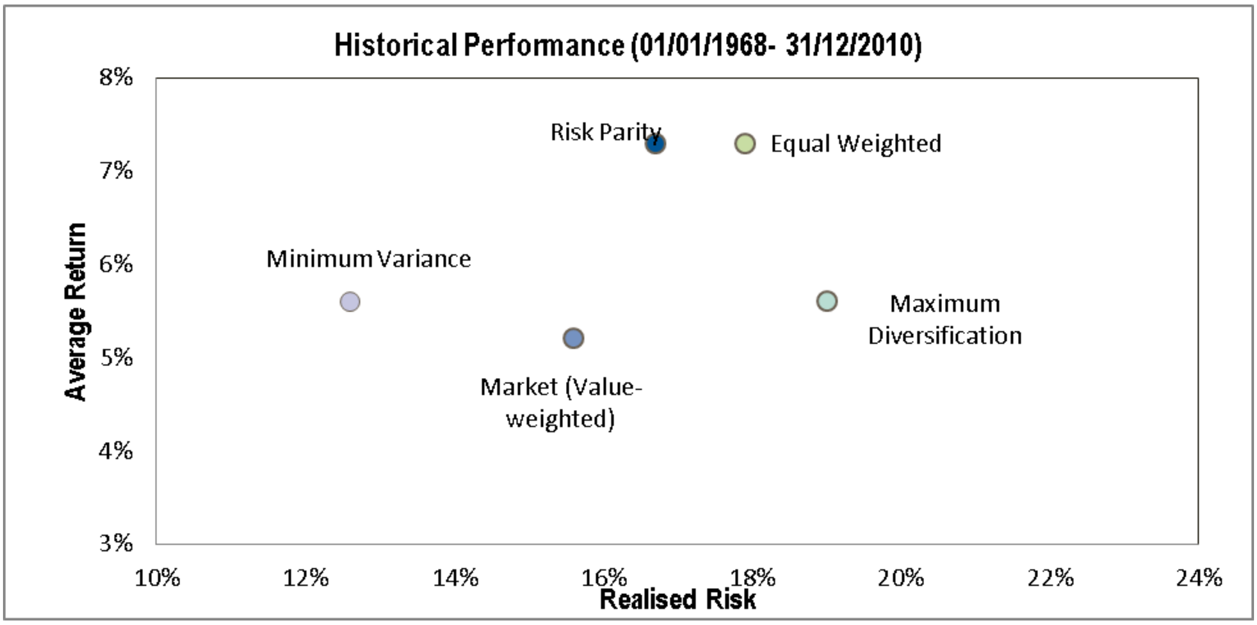
Whilst such a decision might be appropriate to the asset / liability position of some individual funds, it is unlikely to be the case for all funds.

More importantly, it raises important further issues; as the decision about *which* passive strategy is chosen is far from straightforward.

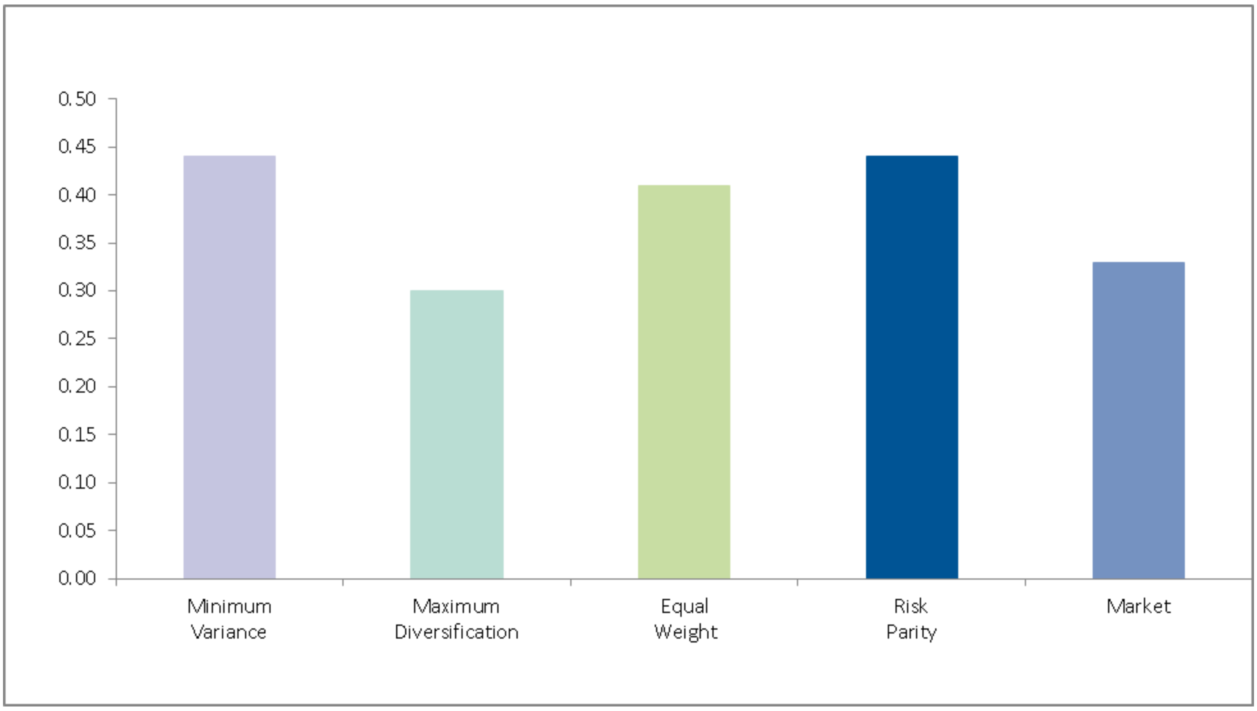
It is not clear what the proposal from the government is in relation to the pooling of listed assets into passive management.

There are multiple different individual developed country stock markets as well as global indices; additionally there are emerging market and smaller company indices; there are capital weighted indices and a variety of 'smart-beta' approaches to construction of passive management mandates.

Research (and intuition) suggests that traditional capital-weighted indices are likely to underperform other passive strategies both in terms of overall investment return and also in relation to other investment characteristics such as Sharpe and information ratios:



HISTORICAL SHARPE RATIOS



Investment universe: largest 1000 US common stocks in the CRSP database at the end of each month
***Source :** Roger Clarke, Harindra de Silva and Steven Thorley, "Risk Parity, Maximum Diversification, and Minimum Variance: An Analytic Perspective", Journal of Portfolio Management 39, p.39-53, 2013. (Charts prepared by Lombard Odier Investment Management)*

If it *is* the intention that all assets should be pooled into one passive capital weighted strategy, which may be necessary to maximise the benefits in relation to fee savings, this research would suggest that the new investment strategy will underperform other available strategies by an amount (possibly significantly) in excess of the fee savings likely to be delivered.

We would expect DCLG to recognise the risk associated with forcing the choice of passive strategy (or choice of market on which it is based) onto individual LGPS funds if it were subsequently to be demonstrated that other strategies would have performed better; especially if such underperformance were to lead to a requirement to increase contributions from employers.

Conversely, if the choice of *which* passive strategy, or combination of passive strategies, is to be left to local authorities; then of course the size of the combined pool vesting into any one particular strategy is likely to be significantly smaller and once again, the promised fee savings might not be fully realized. That is not to say that no savings would be available through pooling; simply that the level of saving may be lower than estimated.

If the focus on costs remains and DCLG believes that regulation of Individual LGPS funds in this regard is required, a better approach may be to cap the overall level of costs that may be incurred in order to access listed asset investments (at, say 0.3% per annum), rather than to force a specific choice of investment strategy driven *only* by its inherent cost.

Addressing the question in relation to 'alternative' investments:

LCPF would accept that fee levels associated with alternative investments can be relatively high in percentage terms; and indeed that when investment size grows, there can be scope for the reduction of fee levels through effective negotiation for *certain* alternative strategies.

However, we question the feasibility of creating an effective CIV (or CIVs) to address pooling of alternative assets, for a number of reasons; and we believe that there are better alternatives.

There is a huge range of different 'alternative' strategies available and currently utilised by individual LGPS funds. Without significant reduction in the range of strategies available, it is unlikely that any significant level of cost savings could be achieved (again, not 'no' cost savings, simply a lower level than predicted).

Reducing the universe of investment strategies available potentially undermines the concept of leaving asset allocation decisions with Local Authorities.

Further, capacity constraints on certain alternative funds (typically also the ones charging the highest fees), such as niche private equity for example, possibly mean that the reality is that there is very limited capacity for fee levels to be negotiated down, *even if it is considered that such an investment is suitable to be made by an individual LGPS fund without the in-house expertise to properly assess it*.

Anecdotal evidence of the attempts of extremely powerful global investment funds to negotiate private equity fees down seems to suggest that the absolute capacity constraints of these niche funds enables them to resist any downward fee pressure.

One approach, therefore, would be simply not to invest. Other approaches, such as co-investment with private equity funds, provide ways to reduce the overall burden of fees without actually reducing the headline percentage level. For example, if one invests £10m in a fund charging 2% annual management charges, but then co-invests a further £10m, the effective management fees would be reduced to 1% across the £20m total investment.

In order to access such opportunities appropriately, however, investment in specialist investment staff is required – as there is evidence of negative selection bias in the co-investment opportunities that arise; and the possibility of damaging overall returns as a result of a quest to reduce fees is a very real one.

We believe that, rather than creating a new CIV for investment in alternatives, a better alternative would be to capitalise on the centres of expertise in investment management that already exist within LGPS, positively building on strength rather than creating something new, with the attendant disruption and cost in terms of additional layers of both staff, regulation and other bureaucracy. Such arrangements need not lead to mergers and need not even be formal shared services simply the pooling of resources (and possibly assets) to manage investments.

We believe that the existing pension fund regulations provide a perfectly acceptable framework for the pooling of assets and resource under governance arrangements that are low-cost but yet effective; and which leave appropriate accountability with administering authorities.

What many individual LGPS funds lack, particularly the smaller schemes, is access to in-house expertise; which leads to an over-reliance on expensive consultants; often giving the same advice in terms of the recommendation of investment funds to multiple different authorities, and charging the same fees multiple times.

This leads to the worst of both worlds – multiple individual LGPS funds which have invested small slices in the same underlying investment vehicles; and all paying premium prices (when compared to the cost of employing in-house staff) for the advice that has taken them there.

This points to an element of the reform agenda which has been lost in the debate around CIV's which is the need to professionalise the management of LGPS. Local authorities must have access to sufficient in-house expertise, either directly or through sharing arrangements to enable them to effectively develop and implement investment strategies. If this were the case a range of the additional costs to which CIV's might expose them will be avoided.

A move to CIV's in the alternative space might also lead to a move away from direct investment in some asset classes into fund structures which may well be more expensive. Our own experience illustrates that for UK property direct investment is around 1% less expensive in fee terms than a fund structure, even using an external manager. Such approaches also do not rule out pooling of resources between funds, for example to make bigger ticket investments.

Funds are also increasingly achieving exposure to more local investment, the Greater Manchester Fund has been successfully doing this for some years, and our own fund and a number of others are now beginning to make investments of this sort. The sort of local knowledge and understanding necessary to make a success of such investments and to identify them in the first place is unlikely to be available through a national CIV structure (which one imagines would end up based in London) and would in our view represent a significant loss both in terms of the ability to diversify LGPS risk exposures but also of a source of funding for important developments within the real economy throughout the UK and away from the City bubble.

The final observation in relation to this question is the lack of any heed being paid to the importance of an effective liability management / deficit reduction strategy. Saving a few basis points of fees in relation to investments, whilst mandating what will inevitably be a more concentrated portfolio, may be more headline grabbing; but what is required is an holistic approach to managing and reducing the deficits faced by virtually every LGPS Fund.

Since 1998, when the majority of Individual LGPS funds had a more comfortable funding position, significant deficits have opened up as funds have continued to focus on driving asset-side growth recommended by consultants rather than on managing and matching their individual investment strategies to the liabilities that will one-day need to be funded.

It is vital that individual LGPS funds take liability management seriously and it is our concern that the asset-side constraints likely to be created by the imposition of CIVs would be a serious impediment to achieving this and therefore making more rapid inroads into the scheme deficit.

Question 2

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

We would entirely agree that asset allocation decisions must remain local, but this does not appear to be what is proposed. At the very least any proposal in relation to the imposition of CIVs would likely reduce the options available to local authorities when making such decisions, if it is really going to be effective in reducing costs (which as we have pointed out is not what we believe should be the primary driver of investment decisions).

Retaining both asset allocation and investment decisions with local fund authorities increases local accountability and diversification of the LGPS investment universe as a whole, reducing the systemic risk that may be created by greater asset concentration.

Of key importance is the fact that retaining local decision making allows funds to manage and allocate their assets in a way alive to the particular characteristics of their liabilities.

Whilst definitely advocating that decisions about asset allocation (and individual investments) should remain local, we would add the proviso that local authorities should have to demonstrate that they employ staff with the relevant expertise to make appropriate, individually tailored asset allocation decisions.

There is much evidence (see report by Spence Johnson, commissioned by Goldman Sachs Asset Management and dated March 2012), that the governance arrangements surrounding a fund (including the appropriate delegation of investment decision making), the employment of suitable staff and the pursuit of consistent investment themes have a significant impact on overall performance, which if implemented consistently throughout the LGPS would far outweigh the sort of cost savings that are considered in this consultation.

It is often the case that local authorities leave the management of their pension assets delegated to less than one full-time employee, not specifically an investment expert, who takes advice from external consultants, often at a cost of significantly more than it would be necessary to pay an investment professional to be employed full time by the same authority.

Even with these resource limitations, stakeholders within individual LGPS funds are currently able to, and do, engage with those responsible for managing funds in order to hold them to account in relation to the nature of and success of investment strategies and not just asset allocation.

It is difficult to see how this will be able to continue with the proposed CIV model, significantly diluting accountability to the wider group of fund stakeholders including local taxpayers. As the proposals stand, accountability and responsibility for poor performance would be separated and it is not clear how local funds will be able to dispose of the services of a non performing manager.

Even if a CIV enables switching between different managers for a particular asset class, the universe of choices will be necessarily constrained if economies of scale and fee negotiating power which are the original raison d'etre for CIVs are to be achieved. However, the CIV managers themselves need to be held to account - this therefore mandates the creation of multiple CIVs; we expand on this further in response to question 3 below.

We would suggest therefore that the creation of CIVs is not compatible with the aim of allowing asset allocation decisions to remain with local authorities. Rather, local authority funds should be required to demonstrate that they are employing their own staff with sufficient investment expertise or to club together with other administering authorities that do (or in order to do so).

We would also contend that the investment approach for individual funds needs to be closely aligned with a liability management strategy individually tailored for each fund, something which requires appropriate in-house expertise to achieve and which it is difficult to see being achieved through CIVs which concentrate only on the asset side of the balance sheet.

Rather than the creation of unwieldy and unaccountable national CIVs, LGPS reform should build on the evidence that greater professionalism of in-house teams drives investment performance. A suitable approach to liability management must be taken to help tackle the thorny issue of deficit reduction as well as reducing systemic risks to the LGPS as a whole. In our view, a wholesale move to CIV's concentrated on passive management and a limited number of alternative strategies singularly fails to address these matters.

Question 3

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

It will be clear from our responses to date that we do not believe that any CIVs need to be, or should, be created, other than as local responses developed by individual LGPS funds themselves as shared solutions to problems they face.

However, if the decision to create CIVs goes ahead, in order to retain the ultimate sanction of removing funds from a non-performing CIV, there would need to be at least two CIVs created in relation to each of listed and alternative investments. However, in order that competition for business remains in the event that an authority wanted to move funds out of one CIV to another, there would realistically need to be three of each type of CIV.

As far as asset 'classes' are concerned, LCPF itself invests in:

Public Listed Equities (global developed markets)
Public Listed Equities (emerging markets)
Emerging Market Sovereign Debt
Senior Secured Loans
Direct Lending to SMEs
Credit Opportunity Funds
Floating rate debt secured on real estate
Floating rate debt secured on infrastructure
Direct investment in infrastructure equity
Infrastructure funds
Direct investment in UK real estate
European Real Estate funds
Private Equity
CLO senior tranches
Short term liquid bonds
Indexed bonds

We invest in Sterling, Euro, Dollar and other currency - denominated assets.

In order that the local asset allocation decisions that have been made to date be respected, therefore, we would expect to see at least sixteen different asset classes available, presumably as sub funds within each CIV, each investable in one of at least three different currencies. However, that would not guarantee that we would continue to be able to invest in the individual underlying investments that have been selected.

If such granularity were preserved, then the likely benefits of reduced fees from the pooling of assets can be expected to be significantly reduced.

Practically, therefore, it would be necessary to reduce the number of asset classes and choices available to local authorities investing in CIVs.

If options were reduced to a bare minimum whilst preserving the ability for local authorities to retain the appropriate level of asset allocation, we would see the following choices of sub fund needing to be available within the 'listed' space:

Active global equity;
Active emerging Markets Equity;
Passive global equity (capital weighted index);
Passive global equity (equal weighting strategy);
Passive global equity ('smart-beta' strategy);

Assuming that they are expected to be treated within the 'listed' basket, the ability to invest in a manner suitably tailored to a liability profile would need sub funds covering:

Short duration UK gilts
Medium duration UK gilts
Long duration UK gilts
Short duration Sterling bonds
Medium duration Sterling bonds
Long duration Sterling bonds
Short duration indexed bonds
Medium duration indexed bonds
Long duration indexed bonds
Short duration global bonds
Medium duration global bonds
Long duration global bonds
Emerging Markets sovereign debt (actively managed)

Assuming that 'alternatives' is intended to include everything that is not 'listed', we would see the following sub fund options being necessary at a bare minimum in order to retain genuine asset allocation choice:

UK real estate (specialist income, core, opportunity, agriculture investment options)
Global real estate (specialist income, core, opportunity, agriculture, timberland investment options)
UK infrastructure equity
Global infrastructure equity
Private equity
Absolute return Hedge funds
Commodities

Senior secured lending (floating rate)
Real estate lending (floating rate)
Infrastructure debt (floating rate)
Balanced global credit

Given the comments above, it is not clear how CIV's will differ from the various framework agreements that are currently being developed, other than in imposing a range of additional costs for LGPS funds which invest in them.

It is our observation, therefore, that once the actual implementation issues are taken into account, the creation of a solution for the LGPS that involves the creation of a number of CIVs will have to either:

a. Significantly compromise the ability to retain asset allocation decisions and accountability at a local level; or
b. Create so much granularity of choice that a significant proportion of the expected benefit from the pooling of assets will be lost; possibly to be outweighed by the drag on performance that extra layers of cost and bureaucracy, together with a lack of accountability, could bring.

Question 4

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

As we have made clear, we do not believe that any type of common investment vehicle would offer a beneficial structure, and that alternative approaches would provide better outcomes for individual LGPS funds.

We are concerned that the Authorised Contractual Scheme model developed for the putative London CIV creates a "manager of managers" and is therefore likely over time to create similar cost disadvantages to those identified by Hymans in "fund of funds" structures. These costs will include some duplication of custody charges and other similar overheads between the individual LGPS funds and the CIV. While not necessarily large this cost duplication seems to have been ignored.

We believe that the existing scheme regulations already provide a suitable platform for the establishment and governance of co-operative investment arrangements that are capable of significantly outperforming a costly regulated investment vehicle wrapper in terms of governance, delegation, accountability and ultimately the ability to address individual LGPS funds' deficit positions.

Question 5

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

We do not believe that any of the options set out in the consultation are likely to offer the best value for any of the stakeholders, nor that it is consistent with the principle of local accountability to look at aggregated performance figures.

We believe that the premise that saving fees should be the primary driver for local asset allocation decisions is fundamentally flawed and that the potential unintended consequence in terms of investment performance, systemic risk and stakeholder disquiet within the LGPS as a whole would be unacceptable.

The first two options outlined, therefore; namely a mandated move (fully or partially) of listed assets to passive management are considered unacceptable.

In addition 'passive' management can be interpreted in a variety of ways and a mandate to move funds into traditional capital weighted index investments virtually guarantees underperformance and a move to the lowest common denominator of investment return; in other words, even a move to passive management still requires active decisions to be made to determine which passive strategy to follow.

We do not believe that the other options, namely 'comply or explain' or 'consideration of passive management' go far enough. Surely the current scheme regulations require local authorities to make informed investment decisions, to document those decisions; and to be held to account for the choices (i.e. that these second two options do not in fact place any additional burden of effective decision-making onto local authority schemes).

In addition "comply or explain" seems to hold out the notion of some form of sanction in the event of non-compliance. It is not clear how this could be achieved within the current legislative framework and, as well as imposing additional cost and bureaucracy, the idea of an Audit Commission type inspection role to achieve enforcement would seem to be counter to the direction of policy adopted by ministers in relation to local government more generally.

We believe that best value to stake holders will only be achieved through the professional management of local authority schemes via the recruitment of, or broader utilisation of existing, expertise directly by individual LGPS funds.

Investment and liability management decisions should be made directly in-house without the need for fees being paid to expensive consultants and fund managers.

<u>We would therefore advocate the introduction of a statutory requirement for administering authorities to transparently account for the fees paid to investment managers, whether through management contracts or via fees embedded within</u>

unitised investment funds and to transparently account for fees paid for investment advice to consultants; and to explain why this level of fees represents better value to pension fund stakeholders than the alternative of employing (either directly, or shared with other authorities) in-house investment staff.

Further, we feel that investment decisions should be made in the context of an asset *and liability* management strategy which has been clearly outlined and which includes targets for deficit reduction against which fund performance can be measured.