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Future structure of the LGPS

- 18th September 2013
- William Marshall
- John Wright

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Call for evidence – five questions

1. Accountability
2. Objectives (2+6)
3. Options analysis and primary objectives
4. Options analysis and secondary objectives
5. What data should be gathered

Agenda today

1. Introduction – overview of the 5 questions
2. Deficits – transparency, do's & don'ts, myths
3. Investments – efficiency & costs
4. Investments – performance & governance dividend
5. Investments – asset pooling
6. Administration – cost & quality, what data is needed
7. Options analysis – Fund Merger, Asset Pooling

Managing deficits

What we'll cover:

1. Clarity & Consistency (Measuring deficits)
2. Assets & Liabilities (Deficit maths)
3. Cash & Returns (Managing deficits)
4. Myths & Reality (What could we do?)

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1. Clarity & Consistency (Measuring deficits)

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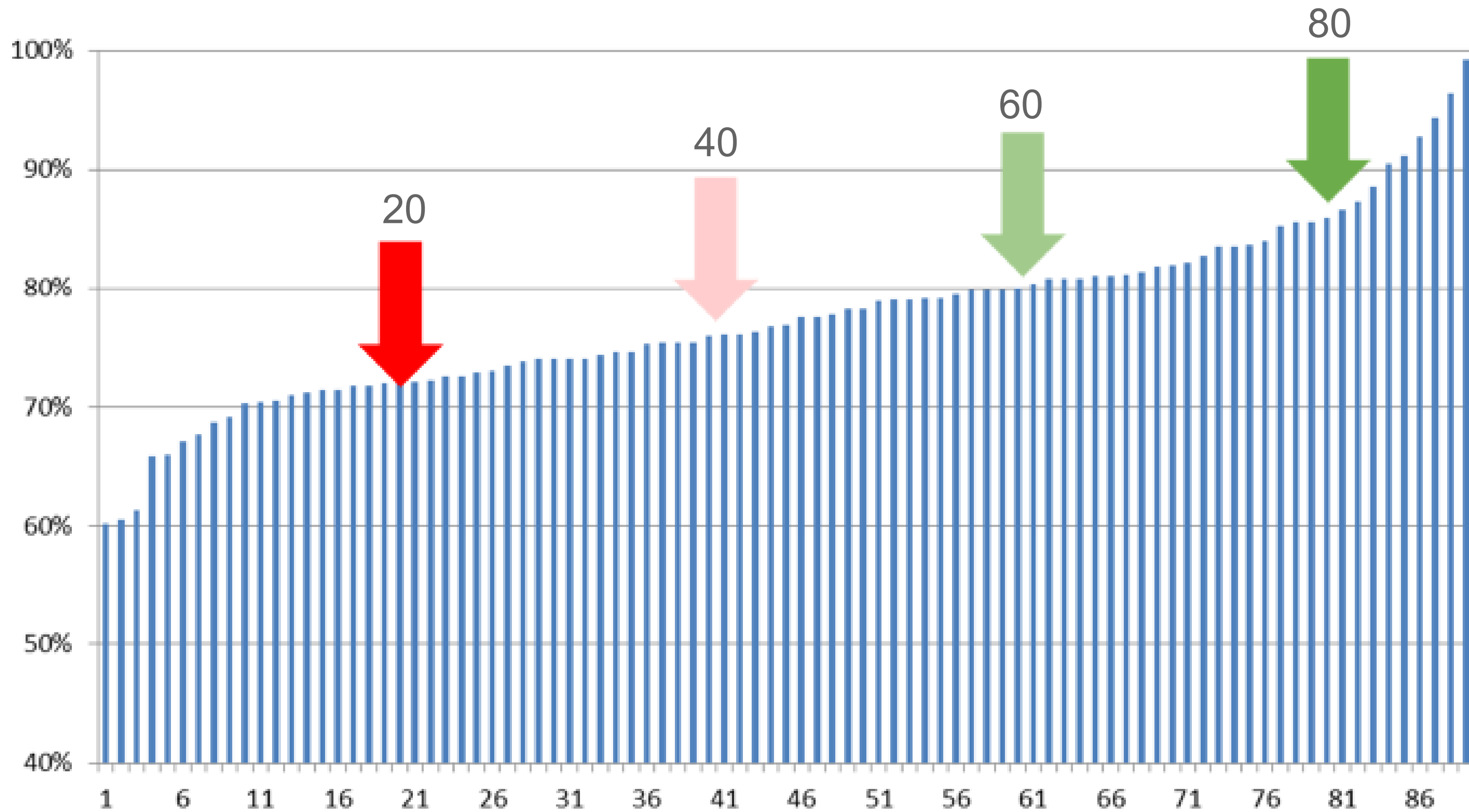
Opaque & Inconsistent



*Figures relate to all English & Welsh LGPS Funds, values based on 31 March 2010 published valuation data

Clear & Consistent

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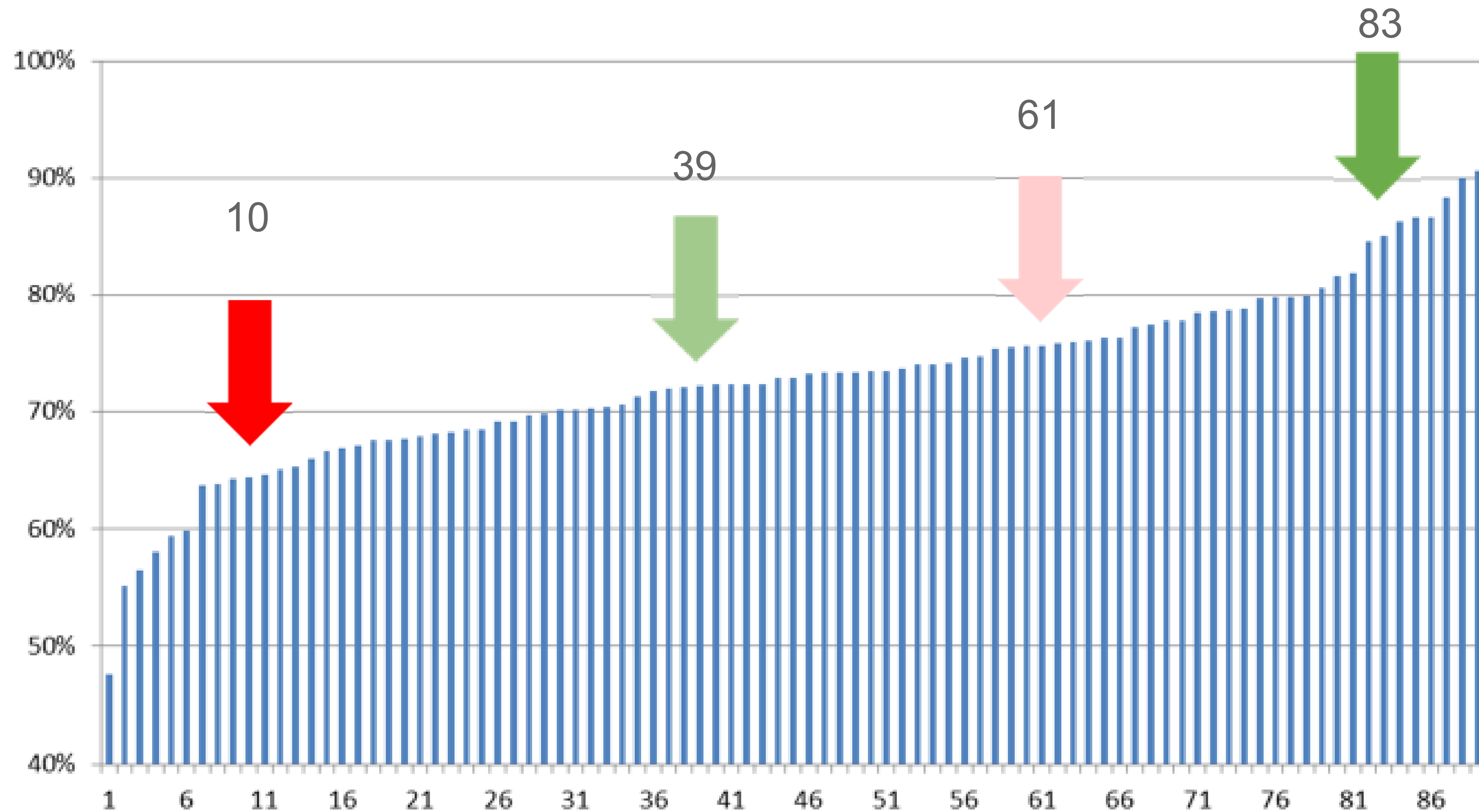
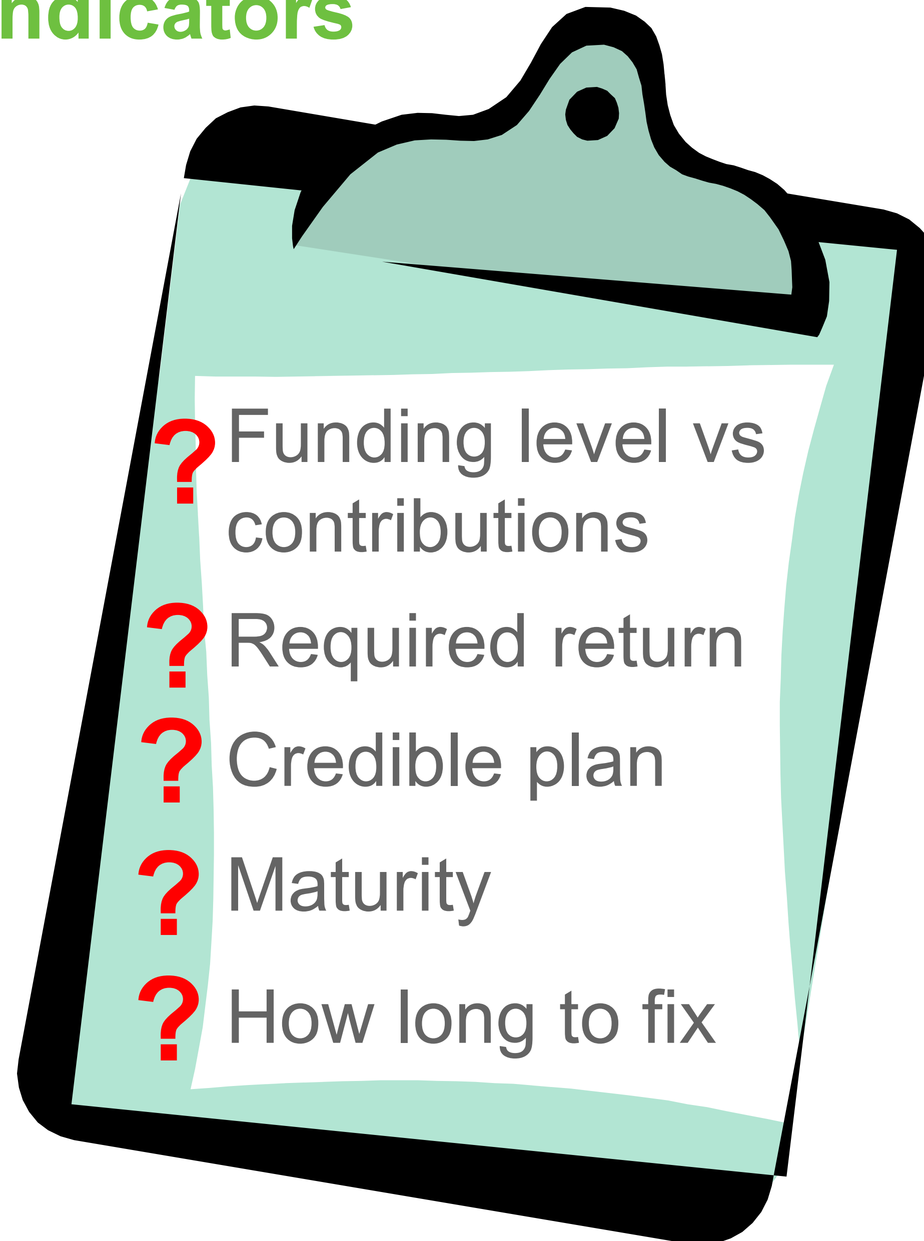


We need to speak a common language

*Figures relate to all English & Welsh LGPS Funds, **estimated** values based on 31 March 2010 published valuation data

REBASED USING HMT FINANCIAL ASSUMPTIONS – NO ADJUSTMENT TO LONGEVITY, ETC

Health indicators



Scheme advisory board or CLG should gather data

Rebased funding level vs contributions

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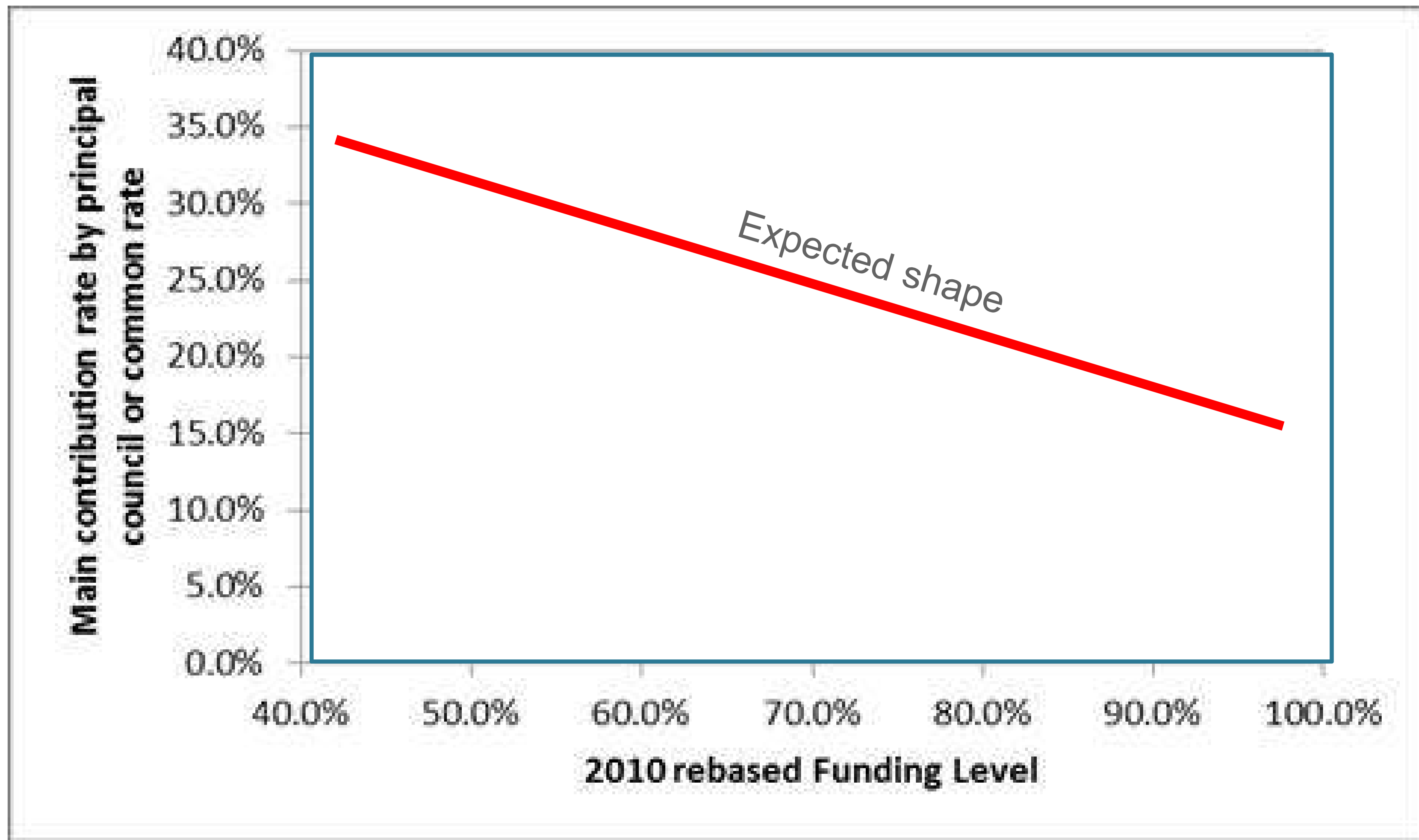
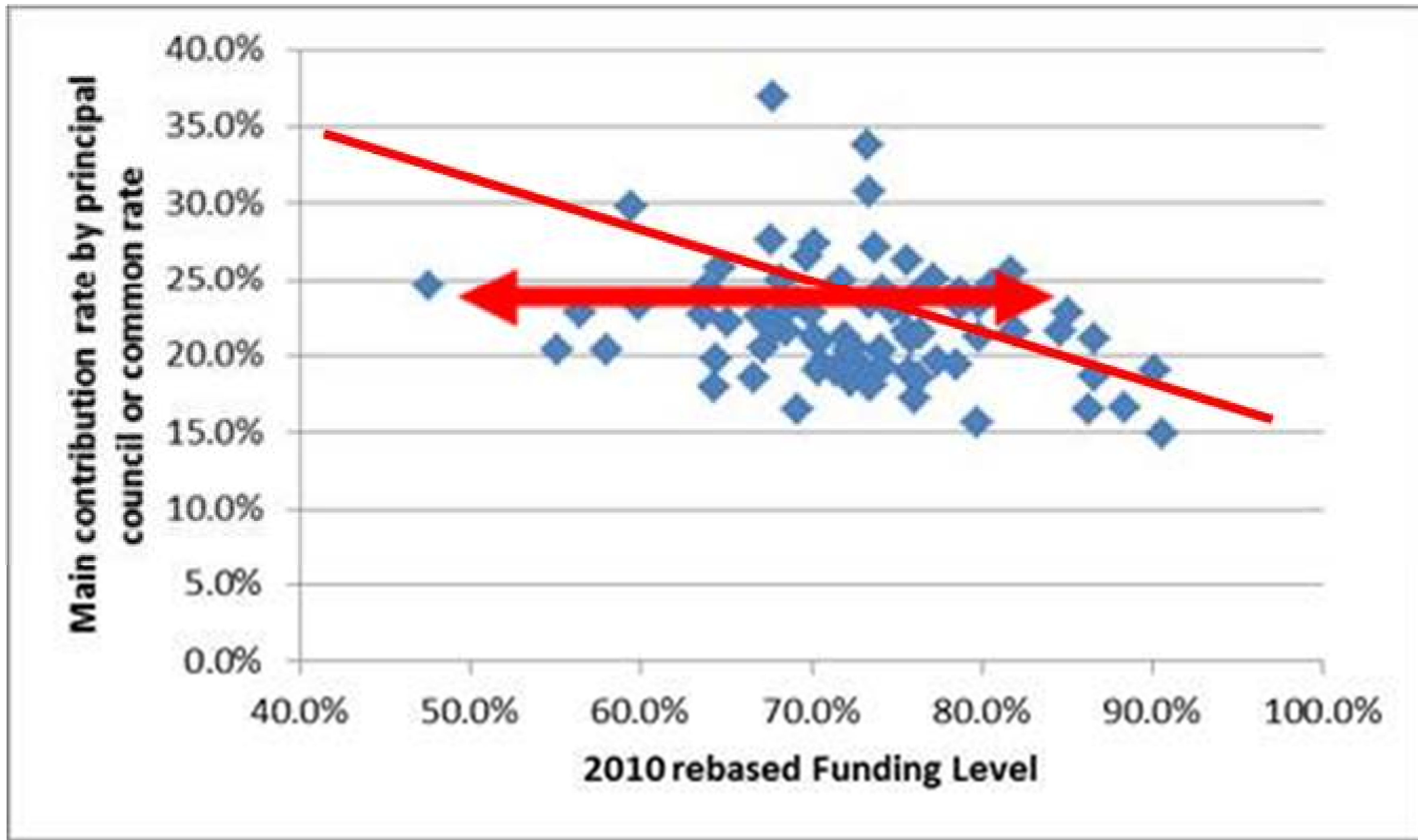


Rebased funding level vs contributions



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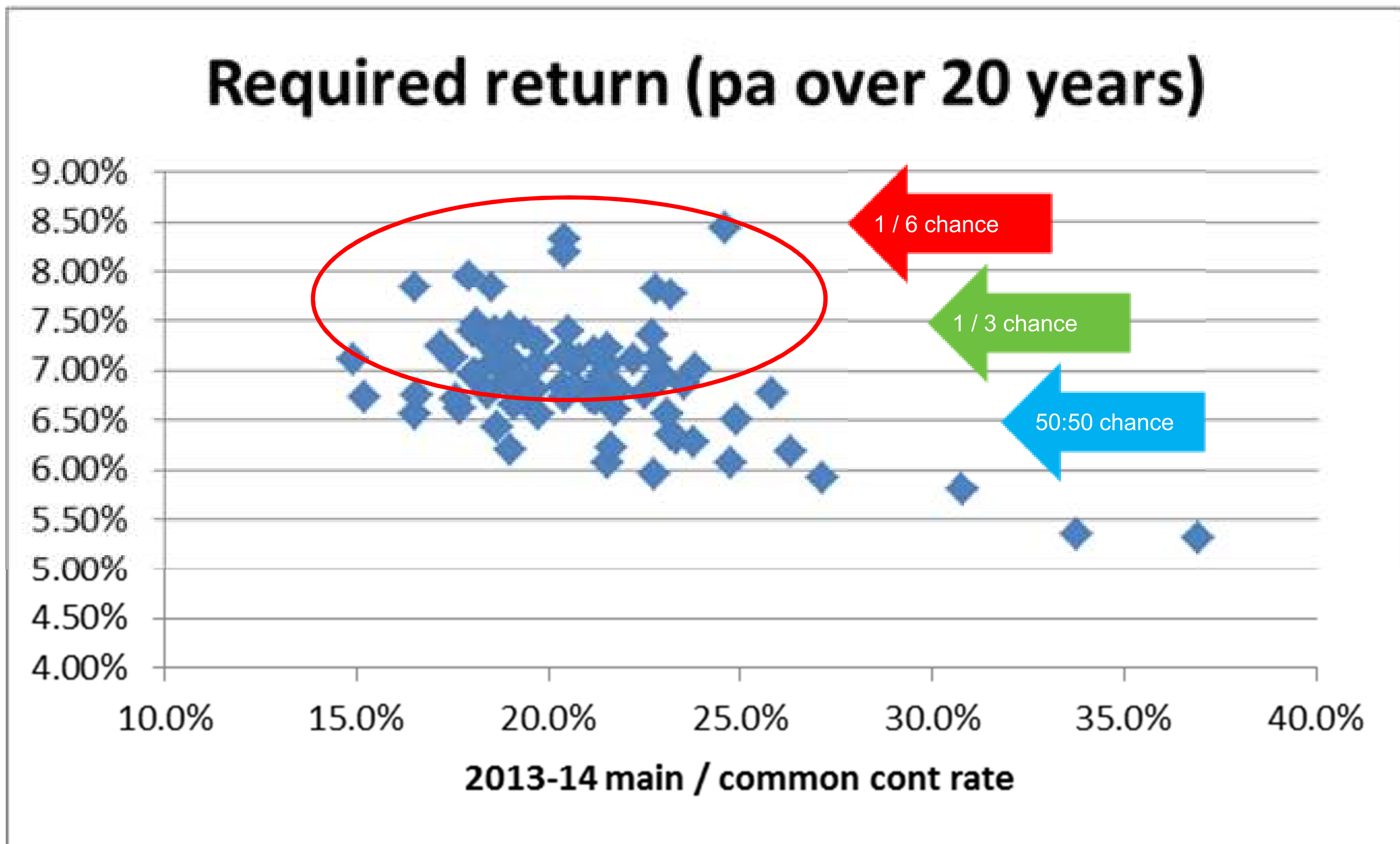
Required investment return



*Figures relate to all English & Welsh LGPS Funds, **estimated** values based on 31 March 2010 published valuation data

Assumed 6% discount rate, 4% real (vs CPI)

Is the funding plan likely to work?

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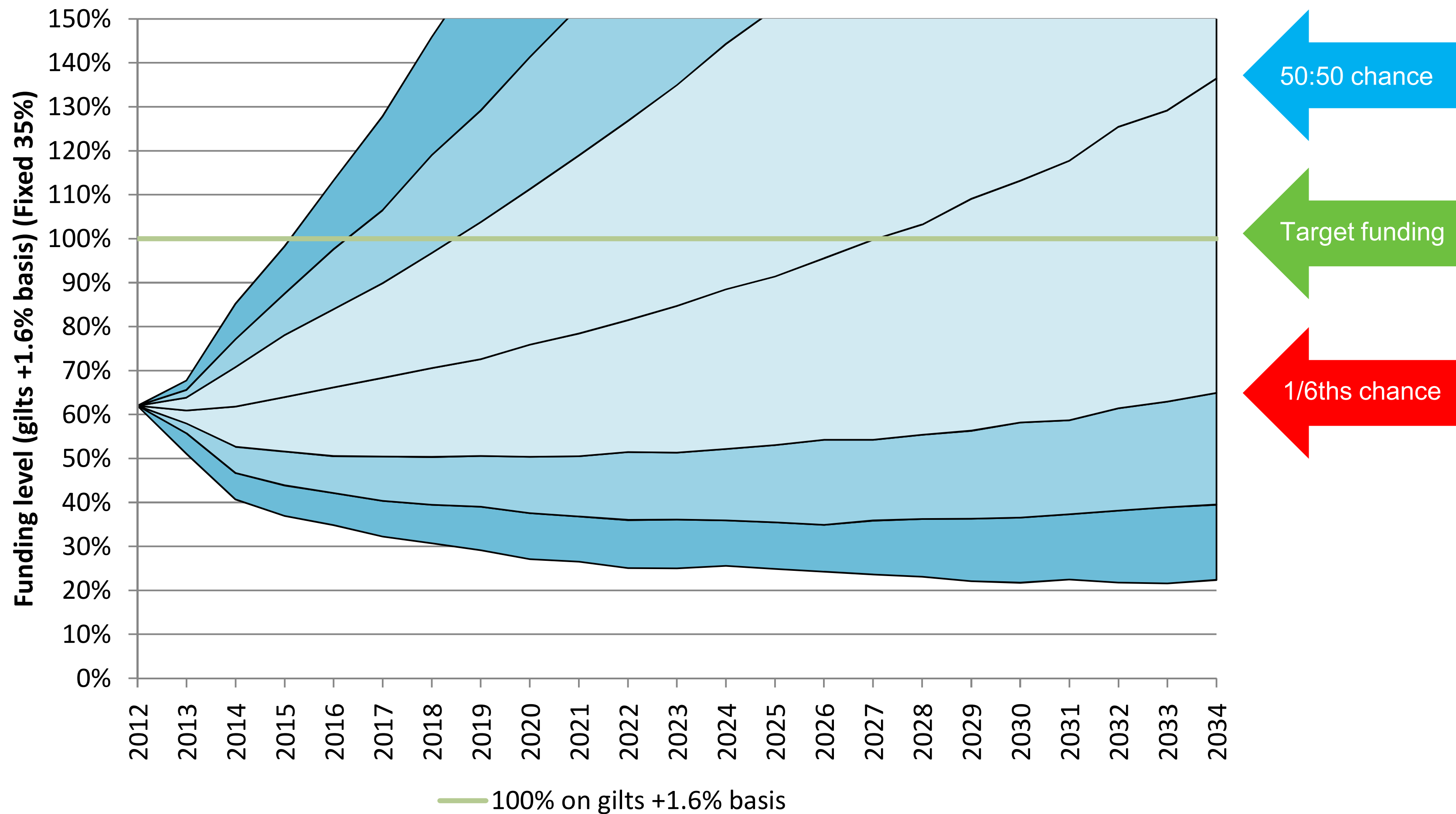

Need to understand the credibility of funding plans

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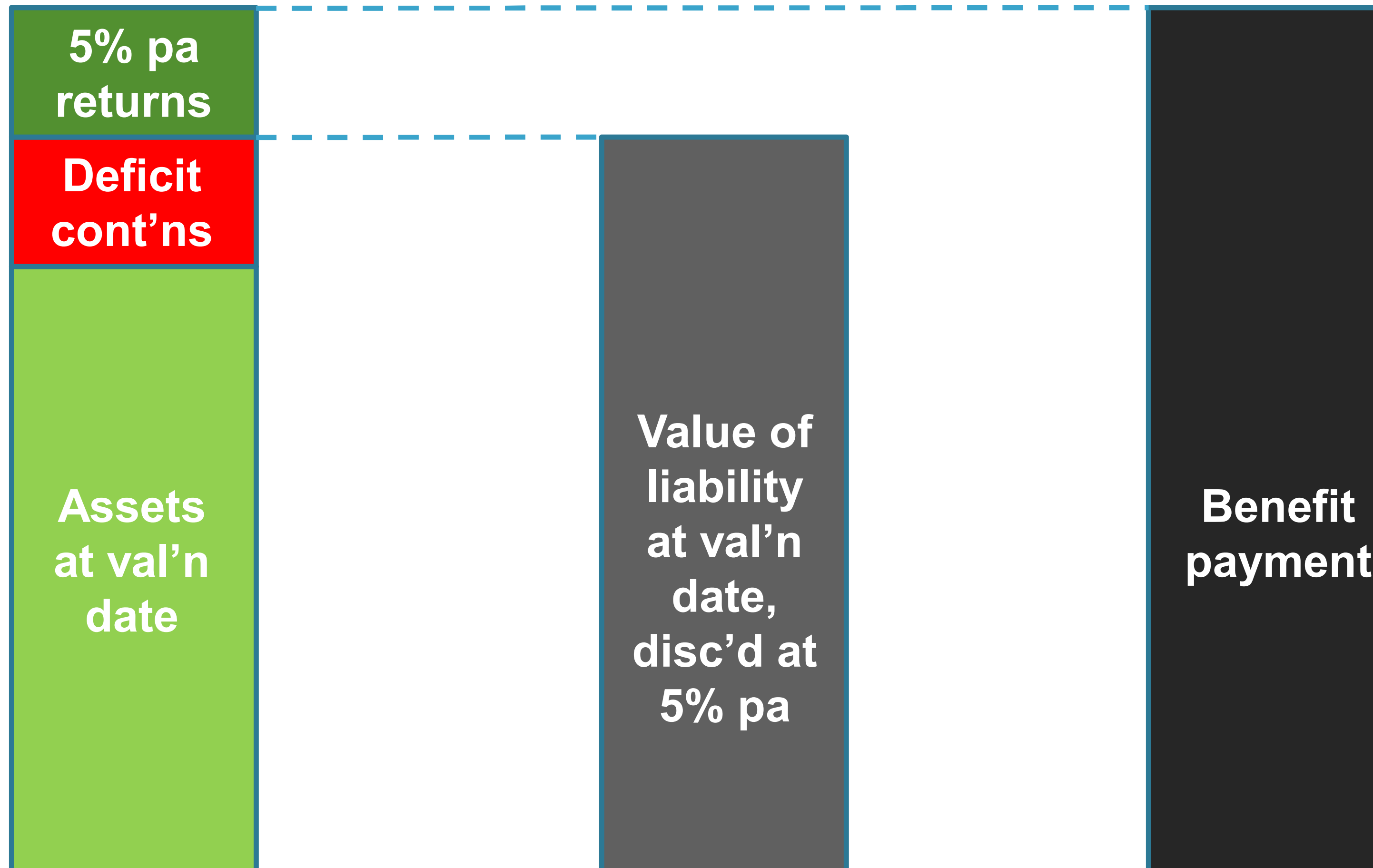
2. Assets & Liabilities (Deficit maths)

Now you see it …



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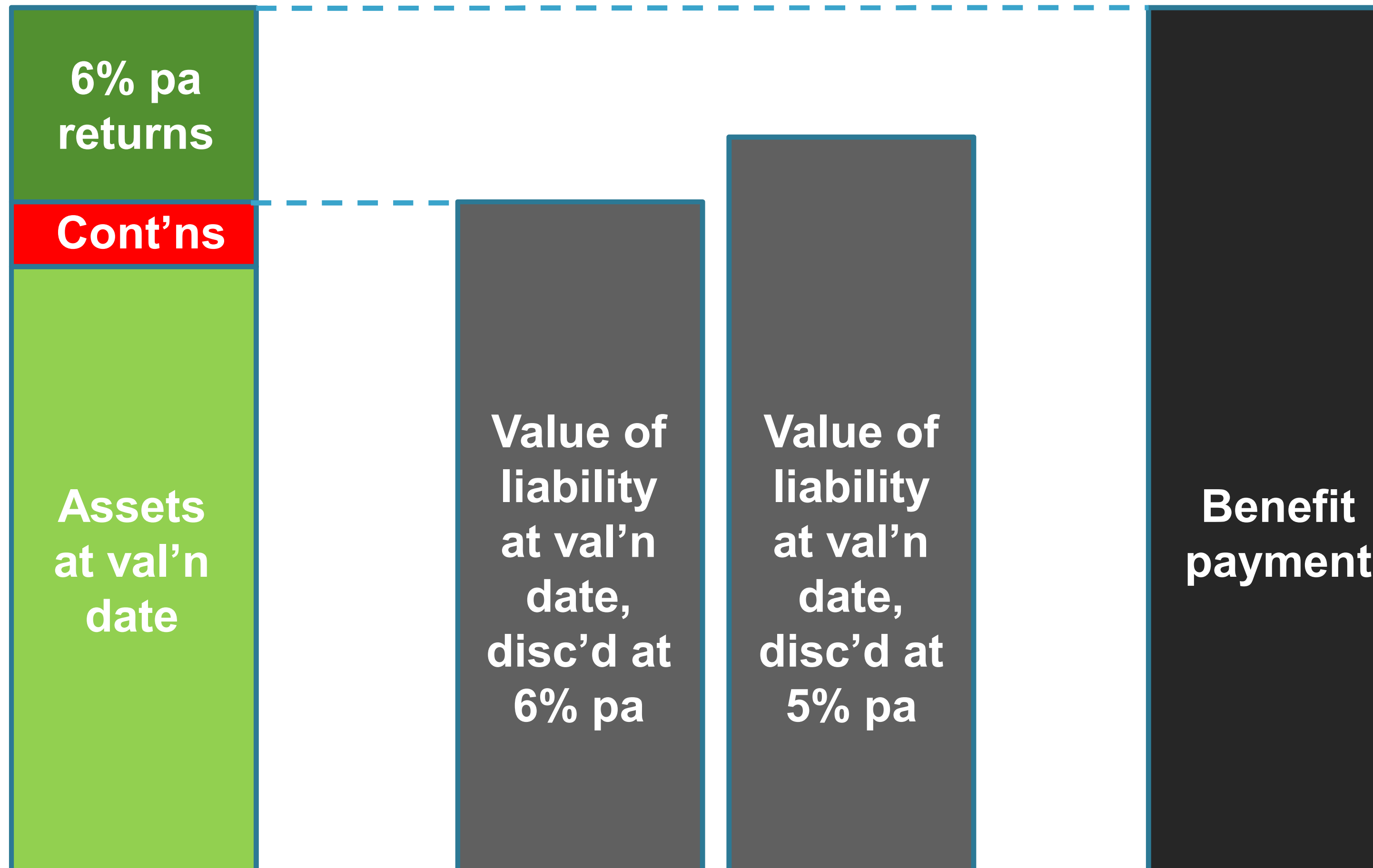
… now you don't?



If use higher discount rate, need to earn on assets

Required return to match interest on liabilities is greater when funding level low

	Assumed return used to value liabilities (discount rate)			
Funding level	5%	6%	7%	8%
100%	5%	6%	7%	8%
75%	7%	8%	9%	11%
50%	10%	12%	14%	16%

Is required annual return achievable indefinitely?

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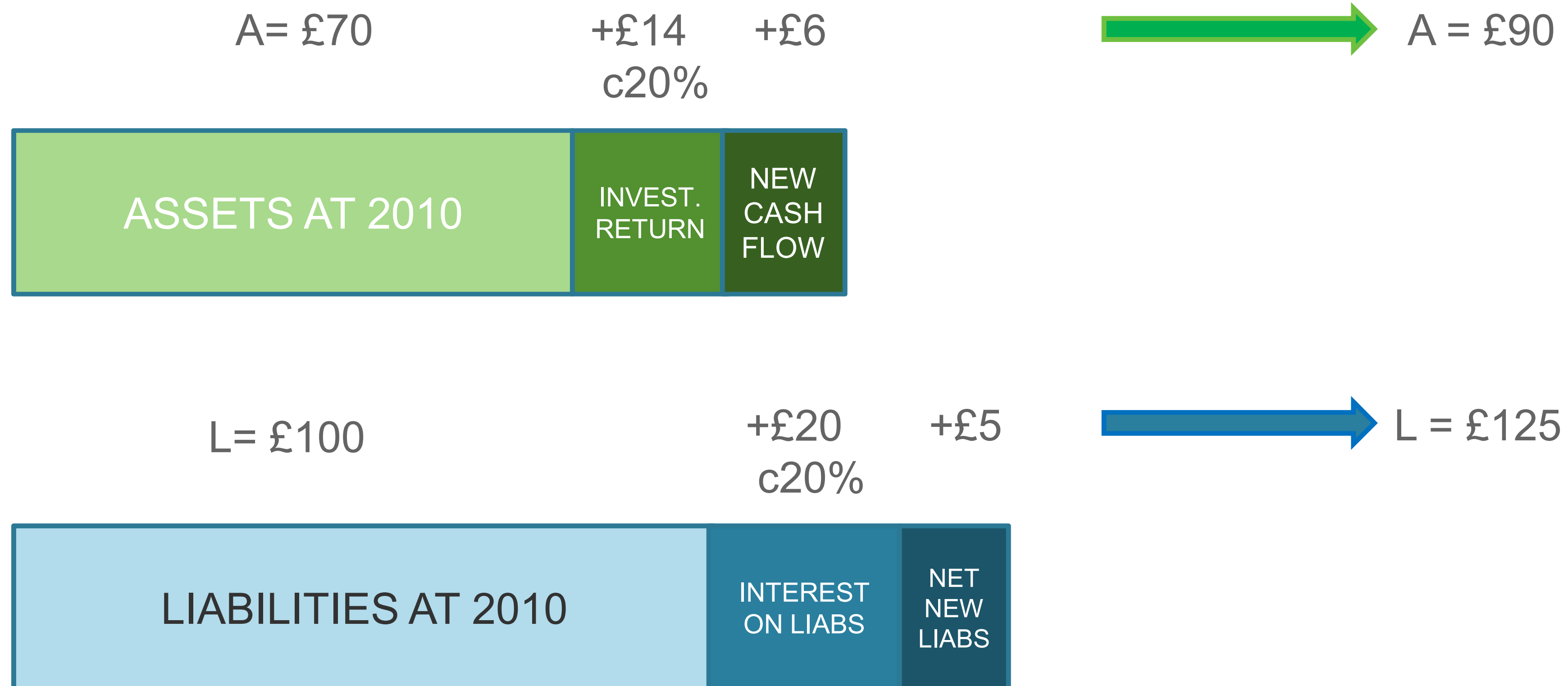
Treading water takes effort



Assets need to catch up with the liabilities

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3. Cash & Returns (Managing deficits)

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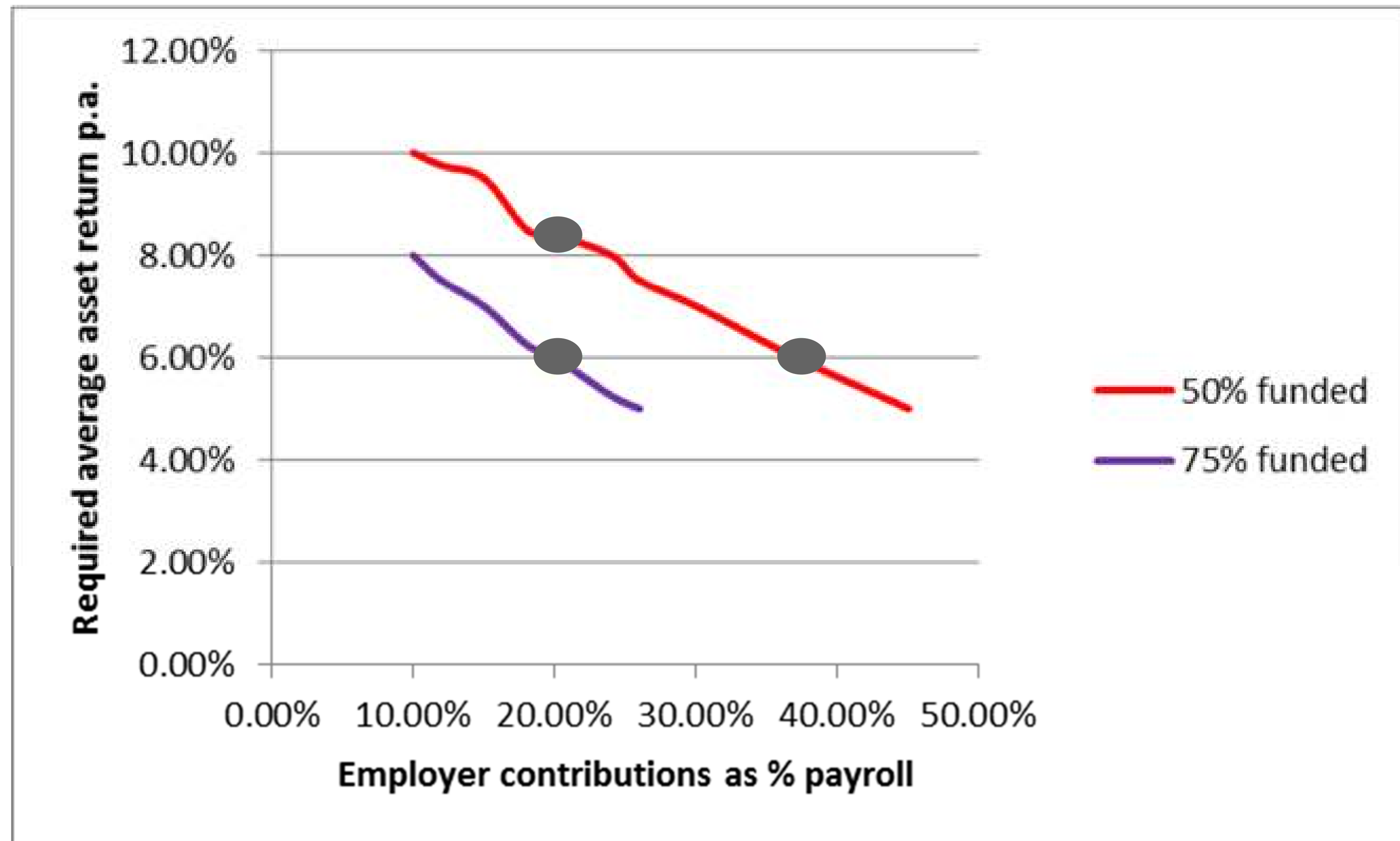
What does it take to repair deficits?



Balance contributions & (required) asset returns

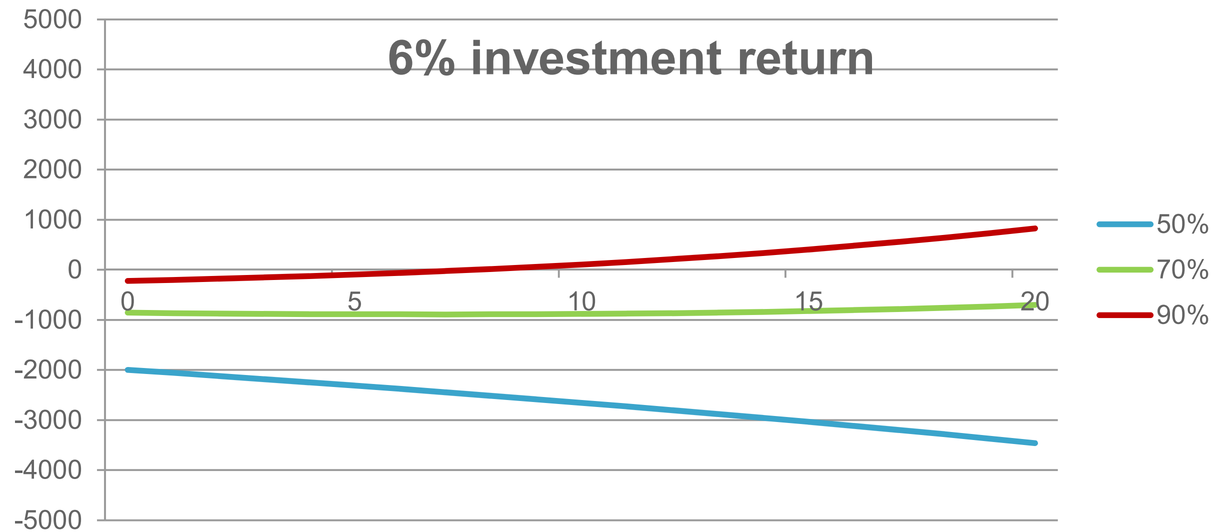
Extending deficit recovery?

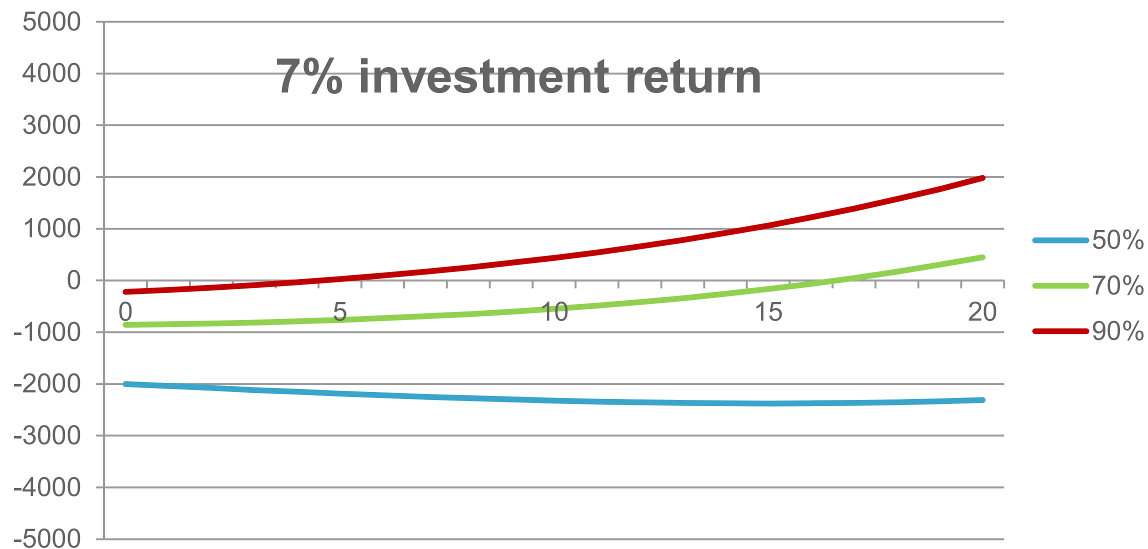
Deficit recovery period	10yrs	20yrs	30yrs	40yrs	50yrs
Annual deficit payments (£) (1st year – inflation increases)	46m	26m	20m	17m	15m
Total deficit payments (£) (present real value)	460m	520m	600m	680m	750m

Diminishing returns

Illustrative example: Deficit amount £400m. Discount rate 6%, inflation 3%.

Can we delay?





Beware the tipping point

FIGURES ILLUSTRATIVE, USING 5% DISCOUNT RATE

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4. Myths & Reality (What could we do?)

Myth busting

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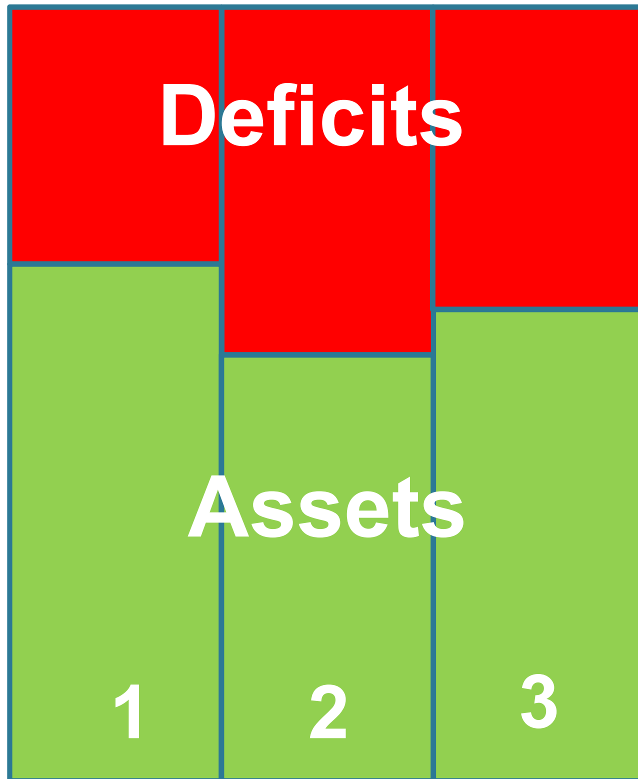
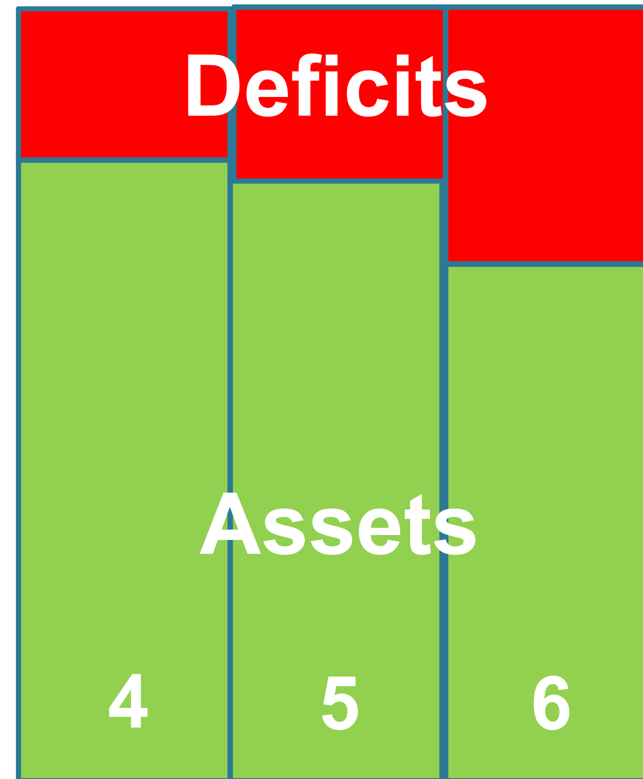
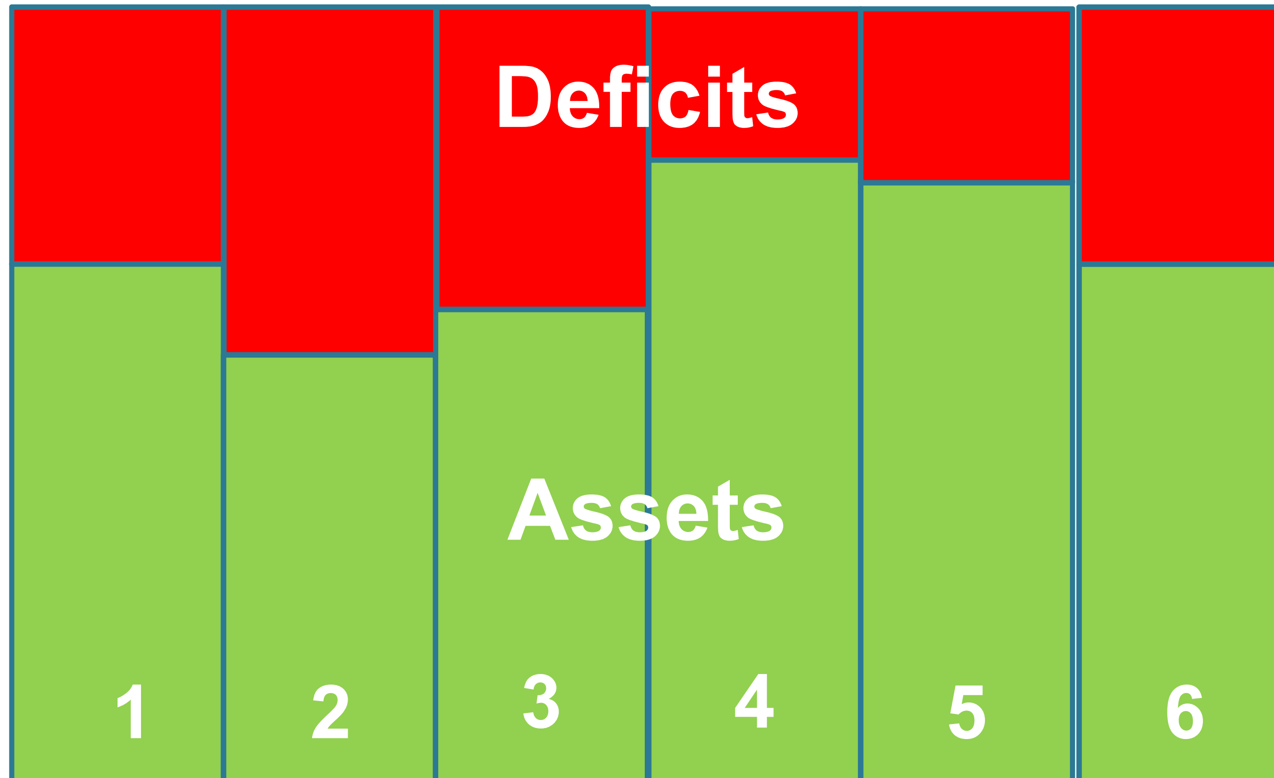
"Hedging will solve the problem"	Lock into current deficit levels? Hedging is expensive in any case.
"The new 2014 scheme will help"	It won't. Deficits are unaffected. Savings (if any) are likely to be relatively small.
"Liabilities should be managed"	Too much is outwith the Fund's control (inflation, salary growth, longevity etc).
"Merger will fix the deficit issues"	See next slides

Now you see it …





… now you still see it



Merger/collaboration just rearranges the deficits, doesn't reduce them

Impact of structural reform

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	Assets	Liabilities	Funding Level
Today	£75	£100	75%
In 20 years …			
7.0% pa asset growth	£290	£321*	90%
7.25% pa asset growth	£304	£321*	95%

A small improvement in net of fees performance can make a big difference

*6% per annum discount rate, ignoring future accruals & payments

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Take home messages

Clarity & Consistency (Measuring deficits)	• We need to speak a common language • Understand credibility of funding plans
Assets & Liabilities (Deficit maths)	• Understand financial dynamics • Assets need to catch up with liabilities
Cash & Returns (Managing deficits)	• Assumptions = requirements • Balance contributions & asset returns
Myths & Reality (What could we do?)	• Combining Funds = rearranging deficits • Better net of fee returns help reduce deficits in long term

Can structural reform improve net returns?

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Investments: efficiency, cost

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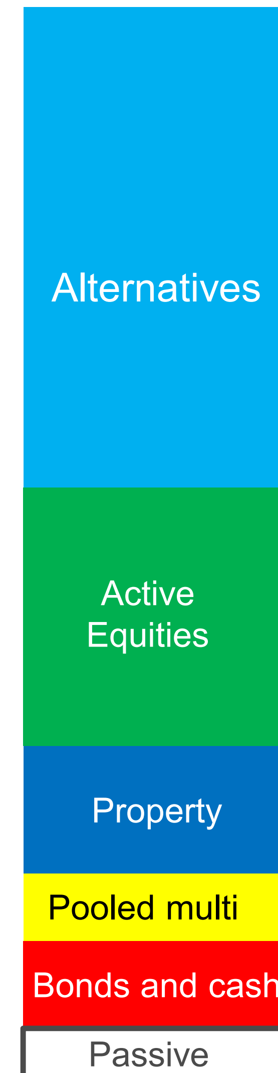
What does the LGPS pay for investment?

Asset class	Annual fees	Asset allocn.	Amount
Alternatives	300-400bps↑	7%	c25bps
Property	90bps	7%	c6bps
Pooled multi-asset	80-120bps	2%	c2bps
Bonds and cash	22bps	21%	c3bps
Passive bonds	10 bps		
Active equities	30bps	63%	c20bps
Passive equities	5-8 bps		

Fee breakdown



- This model suggests typical LGPS fee of **55 bps**
- Fees for Alternatives disproportionate to allocation
  - Leads to questions over validity of “alternatives” model
- Passive management powerful tool for managing fees

Source: Hymans – fees illustrative, not based on any actual fund. Asset split from WM Company (31/3/2013)

Global evidence

- Analysis of 557 US defined benefit pension funds for the period 1990-2010[1]
  - Average costs over entire period **37bp p.a.**
  - But costs increased to **55bp** by 2010 as allocation made to alternatives
  - Scale advantages more pronounced for alternatives than for traditional assets

Source: Can Large Pension Funds Beat the Market?, Andonov, Bauer, Cremers Oct 2012
[1]Using data from CEM Benchmarking Inc.

Cost 'estimates' in the public domain

- Local Government Financial Statistics England (2013):
  - LGPS Investment and admin costs for 2011/12 of £468m
  - 89 funds in England and Wales with ave. total assets of £145.2bn
  - Equates to fee of **32.2 bps**
- London Boroughs cost assessment
  - investment management cost **32bps** on average
- FTfm article published on 28 May 2013
  - (based on research by Investor Data Services)
  - Fee rate disparity; some councils paying three times that of others
  - Article quoted Staffordshire (27bps) and Devon (10 bps)

Are data sources reliable?
What does the LGPS actually pay for investment?

Investment costs – gathering the evidence

- 15 LGPS funds voluntary submitted their fee data
- Independent analysis carried out
- Objective to compare "Combined LGPS" costs with other "Large" global peers
- Factors taken into account, include
  - LGPS size distribution
  - Different asset allocation

Investment costs – the results

	Total (bps)	Additional comments
LGPS	**63.5**	• Direct investment management costs: 61.3bps • Oversight, custodial and other: 2.2bps
Global peers	**58.4**	-

- Costs around double "public" domain estimates
- Investment management costs dominate
- However, gap between LGPS and global peers narrow (c.5bps)

What savings can be made and how?

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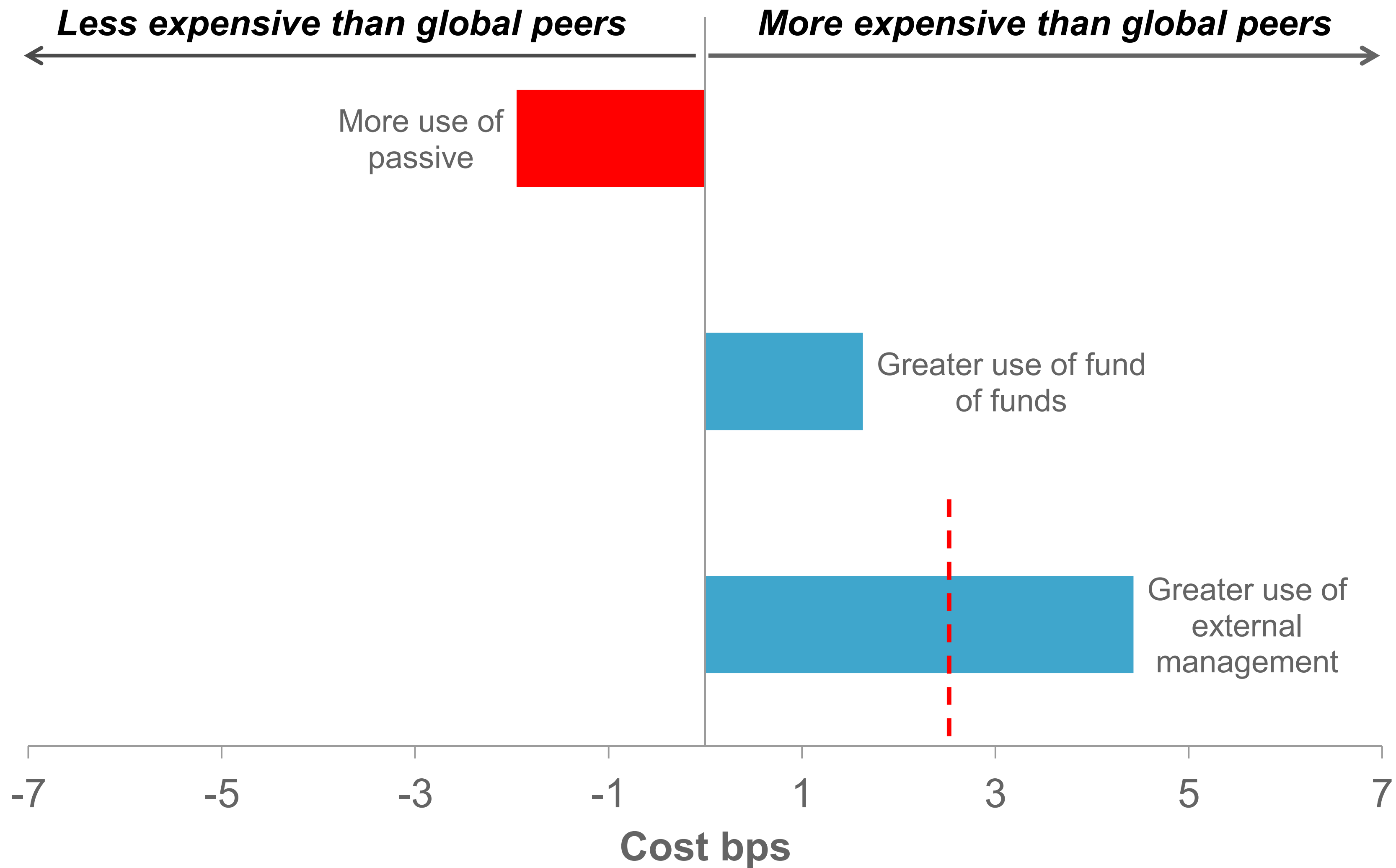
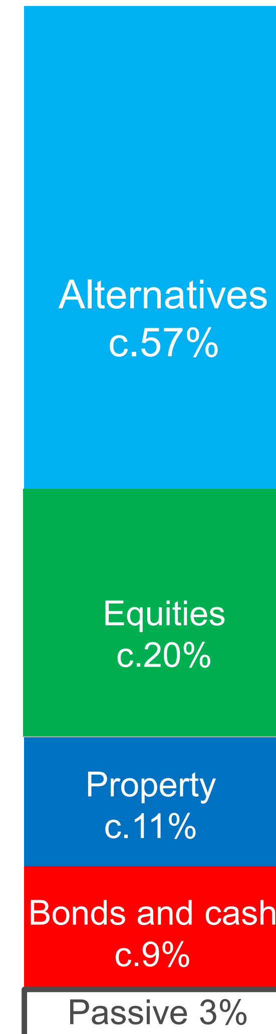
Identifying the difference - 3 big ticket items



Potential to go further

- Alternatives are key drivers of fees
  - c.15% of assets
  - but 57% of fees
- Passive looks attractive
  - 24% of assets
  - But only 3% of fees
- Active fees need to be justified by prospect of higher returns

CEM Fee breakdown



In summary…

- **c.60 bps** should be the new norm for disclosure
- Existing investment fees comparable with global peers
- Potential savings available
  - If you minimise fund of fund arrangements?
  - If you reduce external fund management?
  - If you introduce more passive?

  Collaboration opportunities?
- Broaden project out across the LGPS?
- Ongoing data collection via Scheme Advisory Board?
- Helps monitor progress in improving performance and efficiency over time

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Investments: assessing performance

Performance and fund size

No correlation between size and investment return (but less variation)

LGPS past performance

Returns sourced from The WM Company

	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	Annualised
Median return	7.0	-3.1	-20.3	35.6	8.1	3.0	3.8
Weighted ave.	7.0	-2.8	-19.9	35.2	8.2	2.6	3.8
Index return	7.4	-0.7	-16.1	35.9	7.9	1.8	4.9
Ave. - index	-0.4	-2.1	-3.8	-0.3	+0.2	+1.2	-1.1

- Both median and weighted average returns behind fund index return by 1.1% p.a.
- Results in 2007-08 and 2008-09 very influential

What puts you at the top of the tables?

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- Top 10 funds have avoided very poor performance
- Over longer periods, this compounds to “above average”
- Bottom 10 funds have mix of average and weak performance
- Weaker performance potentially rather damaging
- Over longer periods, this compounds to “below average”

Conclusion

- Maybe surprisingly, don’t need repeated outperformance
- Average performance is good enough; avoid bad years

No need to shoot the lights out!

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Investment structure of top 10

Characteristic	Implication	Caveat
Short manager roster	Reduced governance demands – time to focus on strategy	You need the right managers
Low manager turnover	Reduced costs (transitions)	You need the right managers and patience
Simple structure – equities, bonds and property	Reduced governance demands Avoid ‘fads’	‘Fads ‘ may add value Rebalancing discipline required
Some internal management	Better governance and familiarity with the issues	You need the right internal resources
Evidence of rebalancing 2008-09	Benefitted fully from equity recovery	Frequency and timing matters

2005-12 an unusual period in markets
Did these make the difference?
What will the drivers be for 2012-2019?

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Asset allocation 'drift'
Strategy 80% equities, 20% bonds

Time period	Market environment	Consequence of failure to rebalance
2000-02	Bear market prompted by US tech bubble bursting	Portfolio becomes too conservative – 66% equities, 34% bonds
2003-07	Prolonged equity market rally ended by credit crunch	Portfolio becomes too aggressive – 86% equities, 14% bonds
2007-11	Recession and volatile markets	Underweight equities when rally started in 2009

Impact of rebalancing

£100m portfolio (80% equities, 20% bonds) rebalanced quarterly between equities and bonds:
(period from July 1990-December 2011)

	Final portfolio value (£m)	Average annual return (%p.a.)	Average annual volatility (%p.a.)	Sharpe ratio
Not rebalanced	338.4	7.12	14.50	0.49
Rebalanced	368.2	7.44	14.45	0.52

Rebalancing would have added 32bps per annum

Source: Hymans Robertson

Manager selection: timing entry and exit

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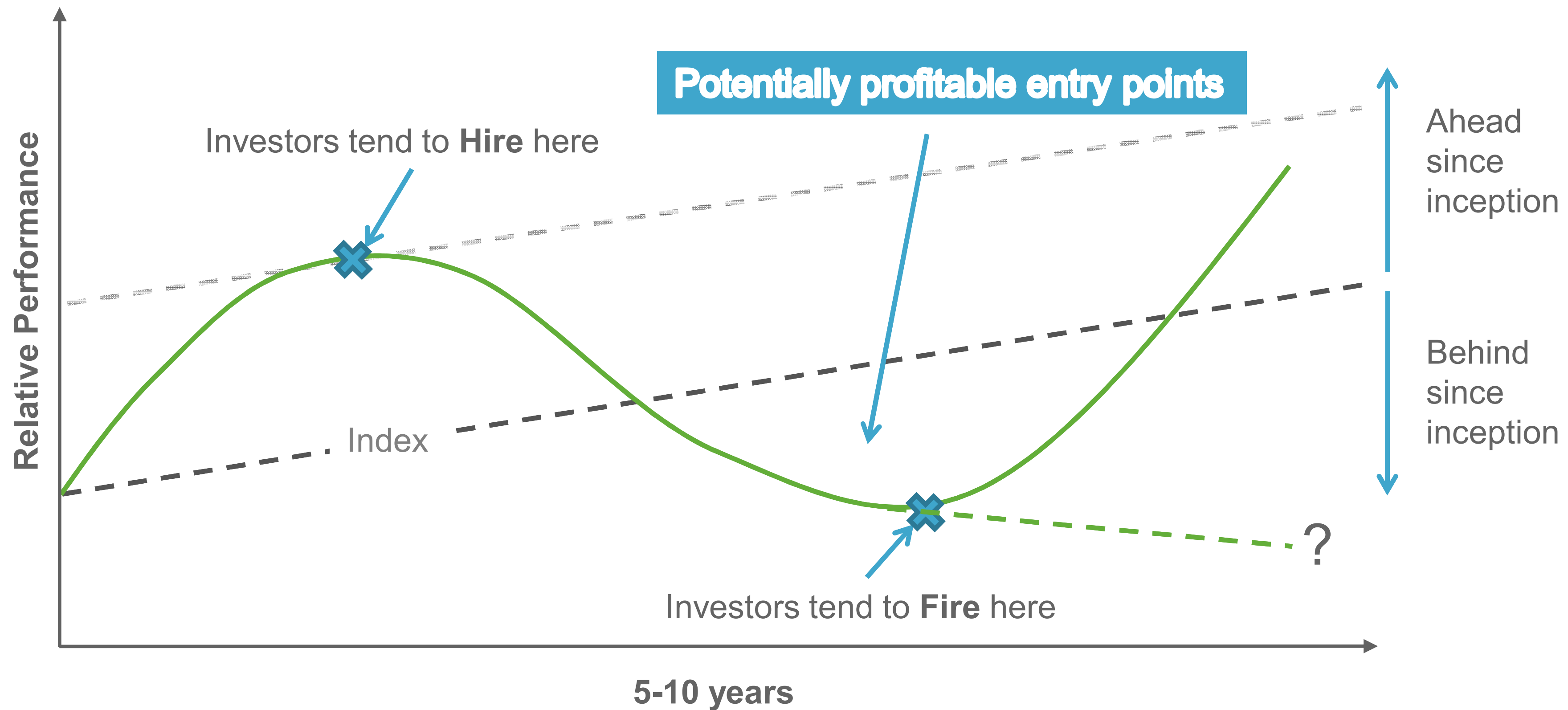

Short-term performance is cyclical and a poor leading indicator

Summary: performance

- No evidence that larger LGPS funds perform better
- General underperformance against benchmark (c100bps per annum over 7 years)
- Don't need top returns every year. Need consistency and avoid bad years
- Top ten funds over seven years: few managers, low manager turnover, simple structures, some internal management, rebalancing in 08-09.
- Caution: will same characteristics always work?
- Rebalance, care over timing hire and fire

Need more data on drivers of good performance, including international comparators

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Performance and governance

The "governance dividend"

"The financial benefit that comes from good management of the pension fund"

- Alignment of interests
- More responsive governance
- Knowledge and skills
- Internal resource/specialists

What do you think good management is?

Governance dividend – what evidence is there?

- Two investigations, in 1997 and 2006, found a positive correlation **between governance quality and** fund performance
- Analysis of CEM database and responses from 88 pension executives showed that funds that scored well on the quality of their governance **spent on average 4 bps p.a. more** than low scoring funds on internal governance, management and control functions

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Governance dividend and the options analysis

- You need to consider the potential to access benefits of governance dividend under each of the options

Status quo | Asset pooling | Fund Merger

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Asset pooling

Why pool assets between funds?

- Scale benefits
  - lower manager fees
  - reduce manager dependence
  - avoid "active fees for passive outcomes"
- Governance benefits
  - Central monitoring and management
  - People familiar with the issues
- Retain some local decision making
  - But need to cede some control eg manager selection, geography?

Scale benefits without fund merger?

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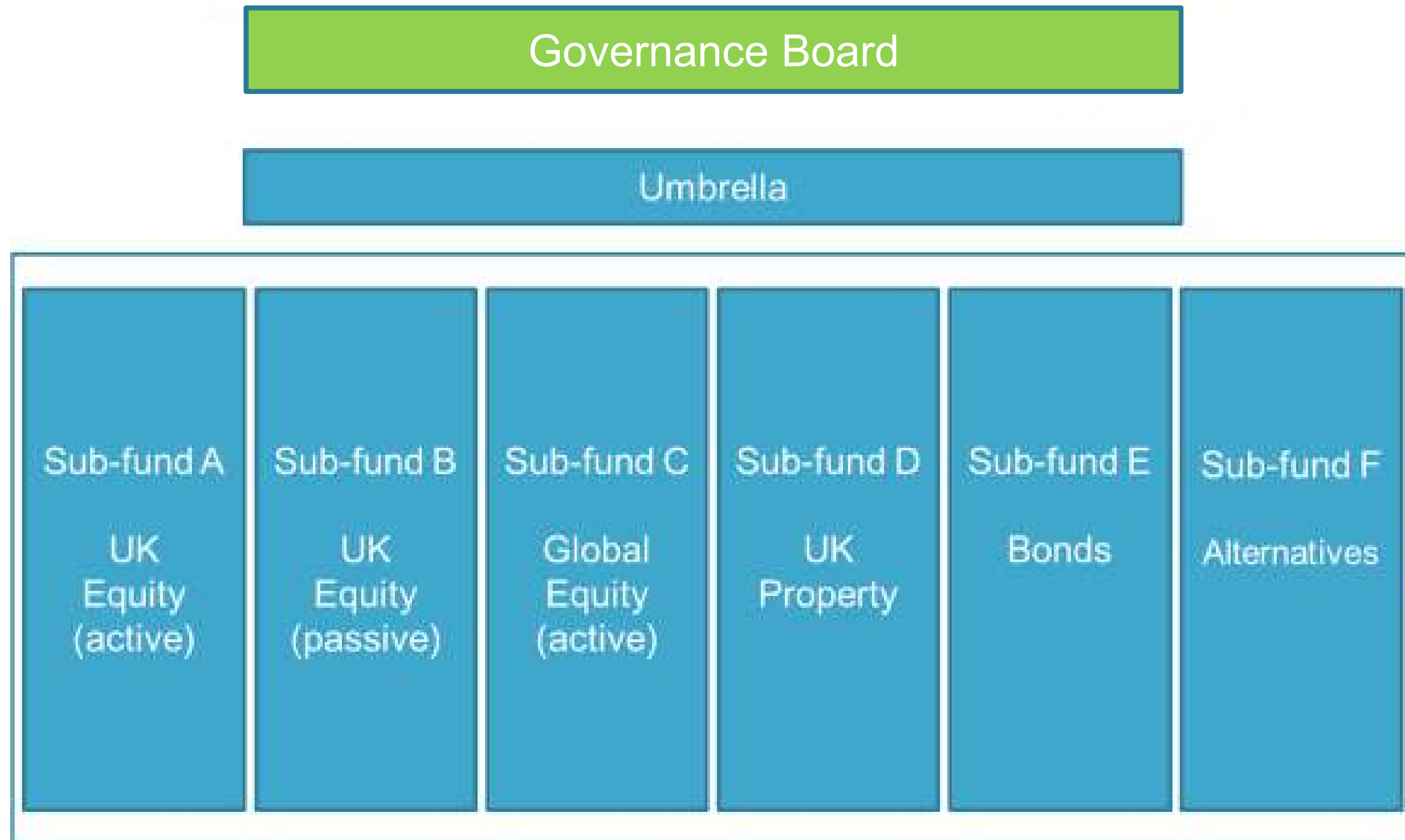
Different ways to pool assets

Options include …	What is it?
1. Fund managers treat LGPS as "one investor"	- Each fund manager treats separate LGPS funds as though were one customer - Individual fund IMAs
2. Common Investment Fund – wrap existing assets	- Multiple asset classes - Tip current mandates into CIF - May change mandates over time - Individual funds retain ability to choose their preferred mandate within each asset class?
3. Common Investment Fund – CIF board selects managers	- Multiple asset classes - Tip current assets into CIF - Board selects managers - In specie asset transfers + transition

Common Investment Funds



Who's on the board? Voluntary participation?
Which asset classes? Pilot or big bang?

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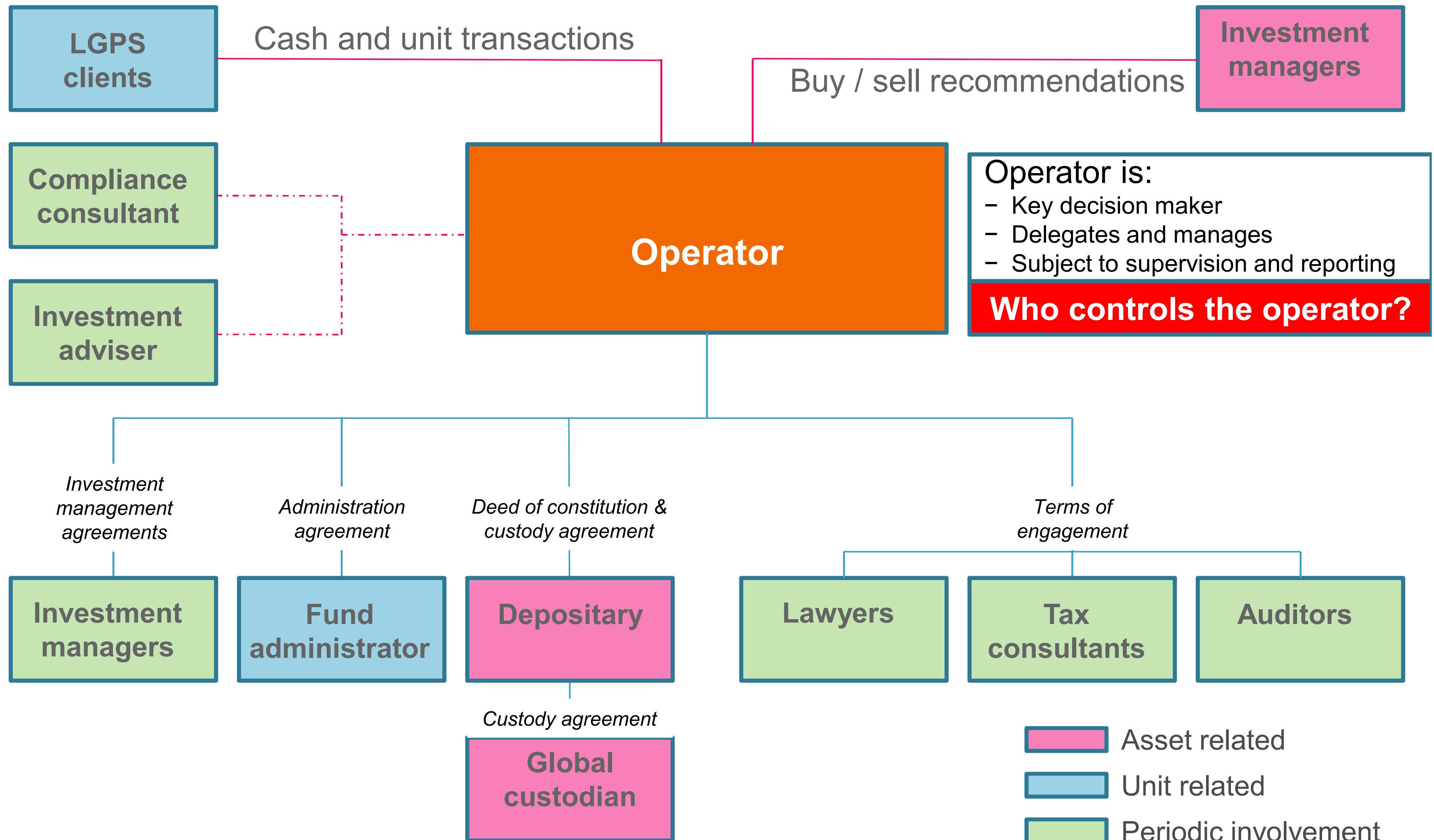
Common investment vehicle – roles



Can you realise the governance dividend?

- Who is the “operator”?
- What internal resources?
- What functions and decisions?
- What local decision making should be ceded?
- Governance arrangements?
- Who is on the Board?

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Administration

Administration costs

- Materiality? (although not a reason for doing nothing)
- What data is there now?
- What data is needed in future?
  - Like for like range & quality of services
  - Allocation of overheads?
- Specify minimum requirements?
- Benchmarking to quantify potential benefits of scale?
- Could be done via Scheme Advisory Board

Better data before making any decision?

Comparing costs

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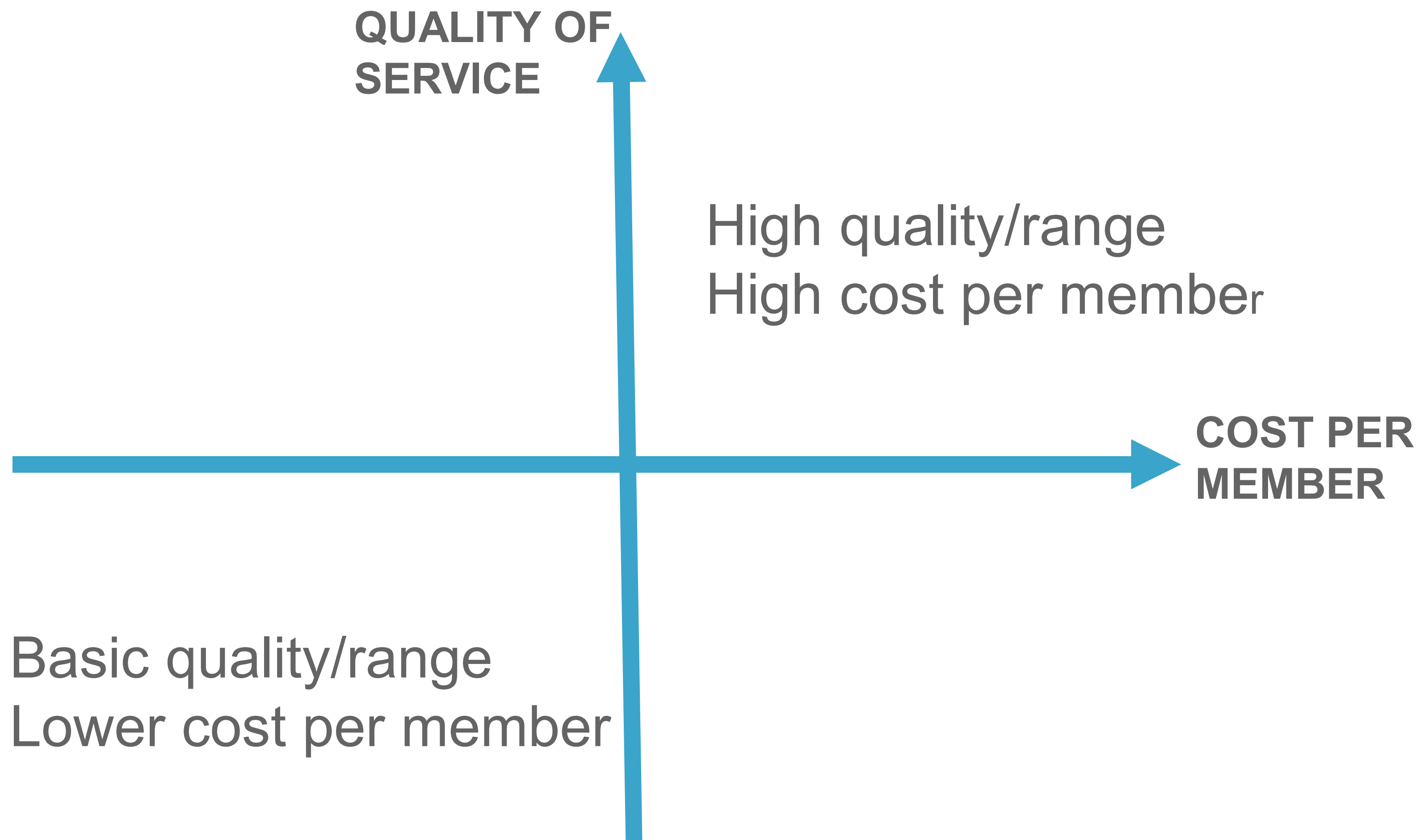

Different Funds may choose different approaches

Options analysis

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Options Analysis

	Status quo	Asset pooling	Fund merger
Investment cost reduction	x	√	√
Governance dividend	x	?	?
Implementation costs	0	+	++
Retain local decision-making	√	√	x
Legislative change required	x	?	√
Deficits reduced?	x	?	?

Summary (1)

- Dealing with deficits: beware myths, no magic wand, need credible funding plans, small enhancement in returns helps in long term
- Impact of change has to be meaningful - c25bps + pa?
- No evidence bigger LGPS funds perform better
- No evidence of significant manager fee savings from merger
- LGPS manager fees already compare favourable with large international comparators.
- Reduce costs further by using more passive, less fund of funds.
- Don’t need to merge to do this - could use Common Investment Funds on some asset classes

Summary (2)

- Merger costly, unproven benefits, long payback
- Collaboration (including CIFs for some asset classes) is less costly, benefits could emerge more quickly.
- Pilot schemes to reduce risk?
- For meaningful gains, may need to cede some local decision making (e.g. manager selection under CIFs)
- Stronger governance could help improve outcomes regardless of size
- For any option, poor execution will dilute potential benefits

Conclusions

- Insufficient evidence to support case for merger
- Easier and faster ways of improving efficiency and performance
- To help reduce deficits, change would need to produce a meaningful improvement in net of fee returns

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Thank you