Tameside Metropolitan Borough

Greater Manchester Pension Fund

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Dear Victoria,

Greater Manchester Pension Fund is the largest LGPS fund in England and Wales with 280,000 members, 330 contributing employers and assets with a value of approximately £13bn.

The prime focus of this consultation appears to be the scope to improve investment decision making by LGPS administering authorities and thus improve long term investment returns. As such we think it is closely linked to the recent Scheme Governance discussion paper. GMPF has a very successful track record and we believe that there are a number of factors that have contributed to the Fund's good decision making and governance, these include:

1. Stability

- of the leadership of the Fund - many members of the Panel have long service and this experience together with training has helped build skills and knowledge;
- of advice from the Fund's external advisors and in house staff; and
- in the investment management arrangements, appointed managers and other service providers.

2. Economies of Scale

- in terms of lower unit costs;
- the benefits of relatively simple investment management arrangement add to the benefits of scale
- the capacity to buy in external and in-house expertise.

3. Broad Governance arrangements

- the Fund's governance arrangements involve the participation of all 10 local authority employers and 6 trade union representatives in decision making. This helps in enabling decisions to be taken from a long term perspective through the broad participation and the constancy of purpose that develops. This constancy of purpose is complemented by a Core Belief Statement that sets out the Panel's investment beliefs. At the same time our arrangements help in putting a framework of procedures in place to enable fleet of foot decisions to be taken.

Our belief is that good decision making benefits from an experienced and knowledgeable Board / Panel supported by good advice. Stability of arrangements also helps generate justifiable trust and a constancy of purpose that helps deliver on the key aim of a low, stable cost whilst maintaining the solvency of the Fund.

Thus in responding to this consultation, we are looking to focus on factors that are likely to be beneficial to investment decision making.

It is also worth repeating that these are difficult times to be managing a funded, defined benefit pension scheme with the introduction of the 2014 Scheme, the end of contracting out in 2016, the implementation of the 2013 Actuarial Valuation, the structural changes in membership and growth in number of employers, the scale of deficits and an exceptional economic environment.

I set out below the GMPF response to the questions raised in the call for evidence

1. *How can the Local Government Pension Scheme best achieve a high level of accountability to local taxpayers and other interested parties – including through the availability of transparent and comparable data on costs and income - while adapting to become more efficient and to promote stronger investment performance.*

   Employers and local tax payers are presumably interested in the cost of the scheme (employer contribution rate) but for a fuller picture, a comparison of the funding level of other LGPS funds would also be required.

   Assuming that this is the case, the provision of comparative data would be a valid means of demonstrating performance albeit such data would need to be produced on consistent assumptions or revised to consistent assumptions. This is not currently the case and it is not readily accessible. A 3 year publication of these types of statistics is probably the right frequency.

   In terms of comparing performance between funds, a secondary level of comparative data would be useful focussing on key factors that drive performance on a qualitative and unit cost basis, e.g. net investment returns and administration unit costs. Further work would be required to improve the reliability of the data and consistency of data for net investment returns, but this should not be particularly difficult. Comparison of investment management costs is difficult because there are substantial indirect costs through the use of specialist pooled funds where investment management costs are met by the pooled fund. There are also many risks associated with forming judgements on investment management fees, e.g. where performance fees are paid to reward investment performance.

   An example of qualitative measures would be national standards for key administrative tasks for both administering authorities and employers against which performance could be monitored and published.

   There are many factors that we believe drive performance and cost, taking administration first, these include:

   - economies of scale
   - policies, systems and working practices
   - employer liaison and training
   - employee training and development
   - specialisation
   - quality and experience of staff
   - location

Similar factors apply on the investment side and in addition stability of arrangements, constancy of purpose, clear and consistent beliefs help improve investment decision making by the Management Panel / Board / Committee. **It is critical in publishing performance statistics that such publication does not in its own right lead to frequent change of manager or a change in beliefs that drive investment strategy. Frequent changes are highly likely to lead to long term underperformance.**

Looking forward, the challenges of managing a LGPS fund are growing significantly and this increases the requirement to have measures in place that aim to improve the quality of investment decision making. We know that larger funds benefit from economies of scale and the scope to buy in additional internal and external expertise, but we also know that smaller funds can also perform well. We along with the West Yorkshire Pension Fund and the LGA have commissioned some research from WM (the leading pension fund investment performance measurement company) that examines past performance and comments on factors that drive performance. We also believe that investment performance can be improved by creating pools of money for specific investment purposes from funds working together but we also recognise this requires a desire for joint working and it can have regulatory implications

2. *Are* the *high level objectives listed above those we should be focusing on and why? If not, what objectives should be the focus of reform and why? How should success against these objectives be measured?*

Yes, they are the right objectives to help deliver a sustainable and affordable scheme to employees, employers and the tax payer.

There are limited options to dealing with deficits. Of these options, the preferred choice is improving investment returns compared to the requirements and consequences of other choices.

The response to the first question flags some of the difficulties in making fair comparisons and thus understanding the scale of the deficit problems and credibility of deficit repair plans.

It is possible on a 5 year to 10 year perspective that we could continue to experience a low return environment. This could result in deficits growing. However, looking to the long term and based on historical long term asset returns, there is a good probability that investment returns will exceed the 3% real assumption built into GAD's costing for the new scheme. This means that, in the long term, it is likely that investment returns will contribute to reducing deficits. This illustrates the potential dangers in looking at short term numbers whether favourable or adverse and using such data to make long term policy decisions.

Short term success or failure is not easy to measure. Over time there is likely to be greater divergence of investment strategy between and within funds. What could be measured or evaluated is whether the investment strategy adopted is consistent with the employer's and administering authority's aims and has that strategy been implemented well.

This is a good area for guidance to be developed and issued by the Scheme Advisory Board

3. *What options for reform would best meet the high level objectives and why?*

The work commissioned from WM helps provide evidence to inform the debate. Some of the complexities are flagged in a recent article from the Chair of GMPF Councillor Quinn attached at **Appendix B** that was recently published in September's LGC. There is no single approach that guarantees success.

It is also important to recognise that merger is likely to result in significant asset transition costs and there will be risks associated with creating a new "delivery" fund. Such costs will be significant in evaluating the options for reform.

We highlight below some of the issues identified in the WM report:

The evidence with respect to the benefits of large funds is not clear cut. There have been numerous studies that failed to show a statistically significant correlation between fund size and performance. The WM study does show that the ten year risk return profile of the four largest LGPS funds is better than the average with better returns and below average risk. It also shows that two of the four smallest LGPS funds also exhibit above average performance. Volatility of performance by these smaller funds tends to be higher. WM comment that large funds may have a number of advantages, but that there may be more significant factors which drive performance and reduce risk.

A key outcome of the WM study appears to be that internally managed funds and less complex funds (those funds with 5 portfolios or less – typically using balanced/multi-asset managers) tend to be the most successful from a risk/return perspective. Clearly, fund size is not a significant barrier to achieving 'simple' management arrangements, but it can restrict diversification in that small funds may be more limited in the type of assets in which they can effectively and efficiently invest.

WM have 25 years of empirical evidence showing superior performance from internally managed funds. Reasons put forward for this outcome include: reduced annual turnover of investments (so reducing transaction costs); less need to focus on short term performance (permitting conviction in investment ideas); and reduced management costs.

WM also undertook comparisons with the largest funds in the corporate sector. Of the 10 largest corporate funds, 8 had internal management arrangements.

The evidence also suggests that many of the factors identified as contributing to the success of internally managed funds can also apply to those funds with relatively simple external management arrangements. This enables the governing body of these funds to have an in-depth understanding of the external managers they employ and so are able to take a long term view of manager performance. Simple arrangements lead to larger mandates and thus it is likely that fee arrangements will be more competitive.

Governance

In our opening statement we make clear that we believe that good governance has been critical to our successful long term performance. Our focus has been on fund strategy and on a long-term approach to investments and manager appointments. WM research supports this long-term approach, with strong evidence gathered over a number of years to show that frequent manager changes typically results in a destruction of value.

It is hard to specify what good governance arrangements look like and comparable arrangements on paper can have very different outcomes. However, we believe that good governance is more likely to be achieved by stable Management Panel / Board / Committee arrangements, together with good training, sound external and internal advice, a firm understanding of the Fund's core beliefs and strong leadership.

Diversification

The LGPS has a track record of investing in ‘alternative’ asset classes, such as property, private equity and infrastructure.

Alternative asset classes do have the potential to provide enhanced diversification and high returns. However, costs are also high and the spread of returns between good and bad funds / investments is wide. This means that significant resource and expertise is required in the management of these asset classes to optimize net returns.

Summary

The link between fund size and improved performance is not clear cut. Success is likely to be driven by having in place stable arrangements and the capacity and capability to take good long term decisions.

A critical factor in delivering the high level objectives is the scope to improve governance and decision making at funds that leads to improving returns or delivering investment strategies in line with employer’s expectations.

4. *To what extent would the options you have proposed under question 3 meet any or all of the secondary objectives? Are there any other secondary objectives that should be included and why?*

- **Reduce Investment management fees**

The scale of investment management fees are determined by:

- investment strategy adopted, the asset classes invested in (alternatives tend to be significantly more expensive than other asset classes);
- the way in which it is implemented, e.g. active / passive, external / internal, balanced / specialist;
- fee structure - fixed or performance related;
- size of mandate.

As commented earlier, the important measure is investment return net of fees and relative to movement in liabilities. This will be driven by the key decisions taken by the Panel / Board / Committee in administering their funds.

We believe that the evidence supports the view that larger mandates do benefit from reduced investment management costs. Pooled investing across funds may help to achieve similar benefits, providing that suitable governance arrangements and common objectives can be agreed.

- **Improve flexibility of investment strategies**

Looking forward, it is likely that funds will need to offer a range of investment strategies to meet employer needs. This will be a challenge for many funds since significant up-front investment in staff knowledge and systems is required in order to achieve robust solutions.

The scale of assets invested is often an important element to effective and efficient implementation of investment strategies particularly with alternative investment strategies.

- **More investment in infrastructure**

GMPF is an investor in infrastructure because it is considered a suitable asset class. This clearly needs to be the rationale for investing. The effectiveness of implementation is likely to benefit from larger pools of money however derived.

- **Access to higher quality staffing resource / More in-house investment resource**

The evidence suggests that an effective in-house resource adds value over the long term because of:

1. Lower relative costs
2. Lower turnover
3. More stability and constancy of purpose
4. Capacity to invest in a broader range of asset classes

- **Better value administration**

The evidence from unit cost comparisons confirms that larger schemes are generally lower cost providers. There are however potential issues of local access for scheme members.

5. *What data is required in order to better assess the current position of the Local Government Pension Scheme, the individual Scheme fund authorities and the options proposed under this call for evidence? How could such data be best produced, collated and analysed?*

We suggest that the following headline statistics will be a useful starting point to assess the current position of the LGPS for each fund in England and Wales,

1. Funding level assessed on a common set of financial assumptions
2. Net investment returns over all standard durations from 1 to 20 years compared to:

    a. The fund's benchmark
    b. The LA fund average
    c. Analysis of performance v market

3. Net investment performance v market.

To gather this evidence we suggest the Shadow Advisory Board, or one of its Sub-Committees, be tasked with drafting a questionnaire, which should be issued to each fund in England & Wales. For the sake of transparency, the results should be published which would then be free to be analysed by any interested party in addition to DCLG.

It is also important to look forward and assess the challenges facing the LGPS over the next 10 or 20 years which may be materially different than those experienced over the last 40 years, in particular the changes in membership and rapidly increasing number of employers with potentially different needs.

If you need any further information or clarification, please contact me

Yours sincerely,

Executive Director of Pensions