Annex A

ESSEX PENSION FUND

Response to DCLG consultation:
Opportunities for collaboration, cost saving and efficiencies

Background

The Essex Pension Fund is the tenth largest of the eighty nine LGPS funds within England and Wales. It currently has in excess of 530 separate employers, including over 180 Academies.

The Essex Pension Fund Board operates as the s101 Committee (under the terms of the 1972 Local Government Act). The DCLG consultation was an agenda item for the Board at its meeting on 9 July 2014, and the following observations and evidence are based on the Board's consideration of this matter.

Public Sector Scheme of the Year

Fund of the Year (Above £2bn)

INTRODUCTION

The Essex Pension Fund welcomes the opportunity to participate in a consultation that is central to how the LGPS invests for its future.

It is encouraging that some common themes raised in a large number of responses to last year's call for evidence have now formed the basis for proposals to both:

- keep asset allocation with local fund authorities and
- enable the availability of transparent and comparable data.

The consultation is set against a backdrop of concern that the LGPS:

- is in deficit
- pays active fees, but
- experiences passive investment performance in aggregate.

These are concerns we share – and as a Fund we take each of these matters seriously. However, in considering these challenges we have developed an approach that differs markedly from the direction in which some of this Consultation's proposals appear to be heading. In particular, our approach leads us to strongly oppose any proposals for LGPS Funds to be compelled to:

- join Collective Investment Vehicles (CIVs);
- end successful active mandates

This response starts by discussing the Essex Pension Fund's consideration of the three concerns highlighted above. We highlight the approach Essex has adopted and where we believe what we do is worth sharing with others. We have responded to the specific questions posed by the Consultation and close with two appendices which detail our approach.

DEFICITS

As at 31 March 2013, the Essex Pension Fund had assets expected to cover 80% of its liabilities. Deficits first emerged within the LGPS in the early 1990s. It is worthwhile recalling that these deficits are the product of a number of factors including those listed below:

- the reduction in employer contribution requirements which coincided with the introduction of the community charge;
- the abolition of tax relief on ACT;
- sharp rises in longevity; and
- global quantitative easing.

Overall we expect that active management fees would have had a very minor impact on deficit levels. However, we recognise that any uncompensated management fee is unwelcome and that is why the Essex Fund has over around 50% of its listed assets managed passively and, where active management is employed, strict criteria are used to select and monitor these managers to increase the likelihood of obtaining value for money.

FEES

The Essex Pension Fund Investment Steering Committee (ISC) includes a formal investment fee review of managers it employs within its annual review of investment strategy and structure. Institutional Consultants Hymans Robertson compare the current fees paid by the Fund with each managers published fee quote to the UK pension fund marketplace at large. This is used, where appropriate, to inform fee discussions with Fund managers and give assurance to the Board that the fees charged to the Fund are not out of line with what is typically charged to other pension schemes of a similar size. The ISC is content this is the case.

The level of fees to be paid is an important part of the decision making process on the engagement of fund managers. However, fees should not be viewed in isolation. Fee analysis ought to form part of a proper process which should also embrace performance and diversification. We return to the matter of diversification in our comments on passive management.

INVESTMENT PERFORMANCE AS AT 31 MARCH 2014

Since 1996 the Essex Fund's investment performance has been 7.5% p.a. compared to the Fund's bespoke benchmark. This represents an outperformance of 0.4% p.a. gross of fees.

This investment performance is monitored by the ISC on an ongoing basis. In carrying out this duty the ISC has developed a particular approach which is described below.

The Essex Statement of Investment Principles (SIP) includes a series of investment beliefs (that are kept under review) which are used to shape and maintain the investment strategy. These are replicated in full at appendix 1 and fall under three broad headings:

1. long term investing
2. diversification, and
3. active versus passive management.

The ISC uses these beliefs as a reference point when considering the investment strategy – including the benefits of both active and passive management. This enables the ISC to review the full available opportunity set (i.e. different active approaches and different passive approaches) as it believes restricting the universe reduces the potential value available. It also means we spend time understanding *"why not to invest"* as well as *"why to invest"*.

The SIP (including the Investment beliefs) is consulted upon each year with stakeholders. Adopting this approach allows the Fund's investment governance to be transparent, and the rationale behind decisions around asset allocation and choice of mandate to be clear. The full SIP can be found at:
http://www.essexpensionfund.co.uk/pensionsWeb%20Documents/STATEMENTinvestmentprinciples2013.pdf

In response to the specific questions:

Proposal 1: Common Investment Vehicles

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.

Economies of scale

In our response to last year's *Call for Evidence* we highlighted the concern that investing via large entities (5 or 6 funds nationally) had the potential to generate significant, and detrimental, market impact once trading commenced. Whilst the desire to search for economies of scale within the LGPS is understandable, we have concerns that an approach centred on one listed asset CIV for whole of the LGPS would be vulnerable to the dangers of diseconomies of scale. These must be fully understood, and lead us to conclude that a *"one step at a time"* approach on CIVs is far more preferable to a *"big bang".*

Delivery of savings

There are currently 89 separate LGPS Funds in England & Wales, most of which will use external fund investment managers with whom they will have separate individual agreements.

Active mandates

In many cases fund managers charge fees on the basis of the value of the assets managed, and this is typically structured in tiers with the highest charge for the initial tier of asset e.g.:

45 basis points (bps) on the first £50m;
35 bps on the next £50m; and
25 bps thereafter.

In the example shown above, a Fund placing a £100m mandate will pay a higher overall fee of 40bps whereby a Fund placing a £200m mandate will pay a lower fee of 32.5bps. This arrangement tends to benefit Funds with the ability to place larger mandates and corresponds with our experience, as one of the larger LGPS Funds, in terms of how much tiered fee structures benefit the Essex Fund.

It is probable therefore that combining assets through CIVs will benefit some Funds who are currently unable to place larger mandates. It seems likely that the prime beneficiaries would be smaller Funds.

We note that Funds in London have already established a CIV. We understand that as part of that process there was a constructive dialogue with Fund Managers about participation in that CIV, particularly on the level of fees. That development, along with this *Call for Evidence / Consultation* process leads us to conclude that the conditions already exist for a national collective dialogue with the Fund Management community about the scope of LGPS fee reviews. Such an initiative would not require further CIVs to be established and could commence immediately.

Passive mandates
The fees payable to passive managers are already relatively low. Would a passive CIV be able to deliver substantial savings on top of this once setup and governance costs were taken into account?

Furthermore we note that passive managers use internal trading in order to save transaction costs. A CIV that consists entirely of LGPS Funds reduces opportunities for internal trading if buyers are not matched by sellers.

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

In our response to the Call for Evidence we stated "*Accountability within the LGPS to local taxpayers is fundamental. Elected Members of Local Authorities, combined with representatives of other key stakeholders, offer the best means of ensuring such accountability."*

Asset allocation is fundamental to how LGPS funds set investment strategies and the proposal to keep decisions at local fund level is welcomed. However it must also be remembered that decisions on "*where to allocate assets"* are profoundly linked to decisions on *"how the assets are managed"*. In other words it is a false separation to allow LGPS Funds to continue to determine asset allocation whilst denying the same Funds the opportunity to select active equity or bond mandates (under the first proposal in paragraph 4.30). We return to this theme in more detail in our response to question 5.

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?

<u>Private Equity, Infrastructure & Timber</u>
The Essex Pension Fund currently has the following allocations private equity (4%) infrastructure (6%), and timber (2%).

Access to these alternative asset classes can often be influenced by issues of scale. The opportunity set tends to broaden the higher the amount to be committed. In theory, a common approach therefore makes sense for alternative assets. The issue here though appears to be one of timing.

Our infrastructure, private equity and timber portfolios all include future investments to which we have already agreed to commit monies. As of 31 March 2014 there was £315m committed but not yet drawn down. Exiting such arrangements early is possible, but would be accompanied by financial penalties that are not in the interests of the LGPS. It is therefore clear that any transition to a CIV for alternatives would need to be phased in over many years, and we agree with the observation made by Hymans Robertson that this could take up to a decade. (page 3 LGPS Structure analysis. Hymans Robertson, December 2013)

Property
The Essex Pension Fund currently has a 12% property allocation - around half of the Essex property portfolio is directly invested in individual land & buildings and we expect this to increase to around three quarters. We foresee a number of issues for transitioning such assets into a CIV (change of ownership, asset management & maintenance etc) which in turn raise questions on governance.

We note that collective investing in property was particularly popular in the 1990s via the Local Authorities Mutual Investment Trust (LAMIT), prior to developments in the 2000s within the indirect property market (REITS etc). This leads us to conclude that whilst there may be co-investment opportunities for property, the case for a property CIV has not yet been made.

Listed equities & bonds
Unlike alternative investments, there ought to be no impediments on smaller Funds gaining access to these asset classes. Whilst we are comfortable that Funds should have the opportunity to join a CIV should they so wish, we strongly oppose any compulsion to do so. This conviction stems from our belief that active management has a place within the LGPS, and that individual Funds should retain the freedom to appoint from the full universe of investment houses. Again, we expand on this in our response to question 5.

Whilst accepting that past performance is not a guarantee for the future, our experience shows that long term relationships with Fund managers work best. It is unlikely that all Investment Managers currently filling LGPS mandates could be included within a listed asset CIV. Any CIV arrangement which forces Funds to part company with successful managers will be counterproductive.

Q4. What type of common investment vehicle do you believe would offer the most beneficial structure? What governance arrangements should be established?

The key feature of any CIV should be that it is voluntary, not compulsory.

We acknowledge the work currently being undertaken by LGPS Funds on a voluntary CIV for London. In our view, there is merit in allowing this project the space to develop –

so that future decisions on CIVs elsewhere within the LGPS can be made on the basis of firm evidence of a CIV in practise. *“One step at a time”* is a more sensible approach than *“big bang”.*

Proposal 2: Passive fund management of listed assets

4.30 The Government therefore wishes to explore how to secure value for money for taxpayers, Scheme members and employers through effective use of passive management, while not adversely affecting investment returns. There is a range of options open to Government and the funds to achieve this:

 Funds could be required to move all listed assets into passive management, in order to maximise the savings achieved by the Scheme.

 Alternatively, 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

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 options set out above offers best value for taxpayers, Scheme members and employers?

The Fund’s SIP includes seven beliefs in total (appendix 1), four of which are relevant to this consultation and are set out below:

Active versus passive management

a. Passive management is appropriate for obtaining a low cost allocation to efficient markets

Where markets offer little scope for adding value through active management (such as individual allocations to UK equities, US equities and gilts) passive management is preferred as a low cost way of accessing the market. This does not include emerging markets where the risk inherent in the market and inefficiency of the market lends itself to active management.

b. Active management is appropriate where a market is relatively inefficient offering opportunities for active managers to add value

Where markets offer substantial scope for added value active management would seem appropriate as a way of increasing overall expected return (after fees) without significantly increasing the overall level of volatility in the funding level.

c. ***A rigorous approach to active manager selection improves the chance of appointing an active manager who will add value over the long-term***
An active manager must outperform their benchmark after fees to add value. The selection of an active manager must assess more than just past performance and look into the infrastructure supporting the performance including; business and ownership, philosophy and process, people, risk controls and fees.

d. ***The assessment of active management performance should be taken with a long-term view and take account of the market environment in which returns are delivered***
Active management is cyclical and periods of underperformance from investment managers should be expected so the structure should be such that when the market cycle is unfavourable for some managers it is favourable for others and vice versa. This is expected to deliver added value over the long-term whilst smoothing the overall performance at the total Fund level. Churning of managers leads to additional costs; however, where the ISC no longer views an investment manager's prospects as positive over the long-term, action should be implemented as soon as possible due to the potential downside risk.

Utilising these beliefs in developing the Investment Strategy has resulted in adopting the following approach managing listed equities and bonds:

Passive management: 45%
Active management: 55%.

 Funds could be required to move all listed assets into passive management, in order to maximise the savings achieved by the Scheme.

We maintain that there is a place for <u>both</u> active and passive management. Adopting both approaches allows diversification within the investment firms used. It also manages the concentration risk that can emerge in the replication of certain "market-cap" indices whereby a passive approach can be dominated by a few major corporations.

Mandating Funds to end active management of all listed assets will require a "fire sale" of mandates – many of which have long standing successful records of outperformance. This is clearly not in the long term interests of either the LGPS or its stakeholders. Furthermore, denying Funds access to active management raises serious questions as to whether Funds have the appropriate level of governance.

We also note that this *Consultation* make no reference to the different forms of passive management currently deployed within the LGPS. The Essex Fund currently has part of its passive allocation tracking RAFI indices, as a means to diversify the often underappreciated unintended risks inherent in passive management. Not all LGPS Funds exclusively utilise traditional market cap passive approaches.

 Alternatively, funds could be required to invest a specified percentage of their listed assets passively; or to progressively increase their passive investments.

There are 89 separate Funds in England & Wales. What evidence is there that a “one size fits all” approach is appropriate for each one?

We are also concerned that a compulsion approach will lead to funds implementing changes without thought about the possible consequences.

 Fund authorities could be required to manage listed assets passively on a “comply or explain” basis.

<u>Explain</u>

We believe the Essex fund already sets its investment strategy with a full explanation of the rationale and therefore this is our preferred option.

LGPS Funds have been required to produce SIPs for over a decade. If these are being fully maintained then the rationale, beliefs and approach that underpin each Fund’s investment strategy, including the extent of active & passive management, should be clearly articulated.

If full explanation was made a requirement a more consistent explanation of the LGPS’s stance could commence.

<u>Comply</u>

If a “comply or explain” approach is adopted, it must not lead to an expectation of knee jerk reactions to underperformance during inter-valuation periods. The Fund’s first investment belief is that LGPS funds take a long term view of investment strategy.

However, we note that it is unclear as yet what the LGPS funds are being required to comply to and the sanctions if they do not ‘comply or explain’.

 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

We believe the Essex Fund already sets itself a higher hurdle than ‘consider’ and already adopts the broad principles of a ‘comply or explain’ methodology.

KEY CONCLUSIONS

In summary:

- The LGPS is in deficit for a variety of reasons;

- We are supportive of the consideration of CIVs, especially for smaller funds, but only where the cost benefit has been clearly articulated and there is a proven track record of robust management before implementing any investment;

- We do not support compulsion in the use of CIVs, especially where funds have sufficient scale to implement direct mandates of their own (such as the Essex property portfolio);

- This leads us to conclude that the London CIV should be allowed to develop in a way that subsequent LGPS CIVs can learn from;

- We agree that decision making should be kept at a local level;

- This leads us to oppose any attempts to impose pre-determined levels of passive management for listed assets; and

- We support an ‘explain’ regime and believe this is consistent with the approach already adopted by the Essex Pension Fund.

In addition to the above, we include our investment beliefs in appendix 1 and an initial guide as to how funds that do not adopt this level of governance might apply them to the management of their own funds in appendix 2.

For and on behalf of the Essex Pension Fund

Appendix 1: Core Investment Beliefs

1. **Long term approach**
    - ***a. Local authority funds take a long term view of investment strategy***
      This is largely based on covenant. Unlike the private sector, the covenant underlying the Fund is effectively gilt-edged. This means that short term volatility of returns can be acceptable in the pursuit of long term gain. Whilst there is a need to consider stability of contributions, at current maturity levels and with deficits spread over a maximum of 30 years, it is largely the future service rate which is expected to drive instability. One of the best ways to avoid this is to build in margins over the long term.

    - ***b. Over the long term, equities are expected to outperform other liquid asset classes, particularly bonds***
      Given 1. a. above, there is a preference for a significant allocation to equities in the Fund as over the long-term as they are expected (but not guaranteed) to outperform other asset classes.

    - ***c. Allocations to asset classes other than equities and bonds expose the Fund to other forms of risk premium***
      Investors with a long term investment horizon and little need for immediate liquidity can use this to their benefit as it offers the ability to capture the illiquidity premium on many asset classes, such as private equity and infrastructure.

2. **Diversification**
    - ***a. Diversification into alternative asset classes (including property) is also expected to reduce overall volatility of the Fund's funding level***
      Given that the returns from different asset classes are expected to be delivered in different cycles (i.e. not be directly correlated with equity returns), the use of alternative assets can reduce overall volatility in the delivery of Fund returns without leading to a significant reduction in overall expected return, therefore increasing efficiency.

    - ***b. In the context of LA funds (open, long duration, not maturing quickly and with high equity content), an allocation to bonds does not offer a match to liabilities, but additional diversification.***
      Where bonds are not used for liability matching purposes, an allocation to these assets can be beneficial from an overall risk/return perspective improving the overall efficiency of the Fund. The corollary to this is that bond benchmarks do not necessarily have to reflect the nature and duration of the liabilities (see benchmark section below), but should be set to provide managers with the sufficient scope to add value.

    - ***c. The overweight to UK equities in most UK pension funds is historic and loosely based on currency exposures, rather than a preference for the UK market***
      Although historically the UK may have benefited from better corporate governance, and therefore a higher return, increasingly the rest of the world is catching up and UK equities are not expected to outperform overseas equities over the long term. Given the concerns over market concentration in the UK

market and an increased opportunity set overseas a move towards increased overseas allocation relative to the UK seems appropriate. Concerns about currency risk can be addressed by a separate currency hedging programme.

d. ***Benchmarks***
Where appropriate, benchmarks should represent the full opportunity set. For example, for a global equity mandate, a market capitalisation ("market cap") weighted benchmark reflects a passive allocation to the market (analogous to investing in a passive equity mandate and investing in each stock according to its size). It therefore reflects the investable universe of stocks available and represents the starting point for an equity benchmark.

e. ***To some extent market cap weighted indices reflect past winners, so should be treated with caution***
The regional exposures in the World Index are a function of the relative market cap of the regional stockmarkets. In turn, these are a function of the size of the economy as a whole and how well companies have performed in that economy. One measure of the size of the economy could be its overall contribution to global GDP. However, as has been seen in the UK, many companies in the market have little exposure to the domestic economy and, again, this should not be adhered to too slavishly. At the total fund level a fixed weights regional benchmark is therefore preferred in order to maintain an appropriate level of diversification across markets. This is particularly the case when the allocations are maintained by a passive "swing" manager.

f. ***Emerging market economies may be expected to outperform over the long term as the economy develops and the risk premium falls***
As emerging markets develop both politically and economically, become more robust and less dependent on the fortunes of a small number of developed economies (such as the US), the risk of investing in these countries should decrease. The return demanded by investors for investing in these 'riskier' countries will therefore fall reflecting the increased security. This reduction in required return would tend to lead to a systematic increase in stock prices. As a result, a strategic allocation to emerging markets of at least the market cap weight if not slightly above is favoured.

g. ***Bond benchmarks do not need to reflect the nature and duration of the liabilities***
As discussed in the diversification section above, if bonds are not held for liability matching purposes, benchmarks should be set in order to maximise the scope for adding value.

3. Active versus passive management

a. ***Passive management is appropriate for obtaining a low cost allocation to efficient markets***
Where markets offer little scope for adding value through active management (such as individual allocations to UK equities, US equities and gilts) passive

management is preferred as a low cost way of accessing the market. This does not include emerging markets where the risk inherent in the market and inefficiency of the market lends itself to active management.

b. ***Active management is appropriate where a market is relatively inefficient offering opportunities for active managers to add value***
Where markets offer substantial scope for added value active management would seem appropriate as a way of increasing overall expected return (after fees) without significantly increasing the overall level of volatility in the funding level.

c. ***Constraints on active managers reduce their ability to add value***
Active managers should not be unnecessarily constrained (within appropriate risk limits) and should be given the maximum scope to implement their active views. There is therefore a preference for unconstrained mandates e.g. unconstrained global equity mandates and unconstrained bond mandates such as M & G's LIBOR plus approach. This also suggests that, within reason, managers' requests for additional scope should be acceded to.

d. ***A degree of diversification of managers improves the efficiency of the overall structure (i.e. improves the expected return per unit of risk)***
Active manager performance is expected to be cyclical and therefore by appointing a number of managers the delivery of returns is expected to be less volatile. However, too much diversification can lead to expensive index tracking.

e. ***A rigorous approach to active manager selection improves the chance of appointing an active manager who will add value over the long-term***
An active manager must outperform their benchmark after fees to add value. The selection of an active manager must assess more than just past performance and look into the infrastructure supporting the performance including; business and ownership, philosophy and process, people, risk controls and fees.

f. ***The Fund does not have the governance structure in place to take tactical views and market timing is very difficult***
Both timing investments into the market and taking tactical views are very difficult given the governance structure in place and the time taken to agree and implement decisions. Where possible these decisions are left to professional investment managers who are closer to the market and can implement tactical views in a more timely fashion. This highlights the importance of not unnecessarily constraining active managers and providing them with appropriate scope.

g. ***The assessment of active management performance should be taken with a long-term view and take account of the market environment in which returns are delivered***
Active management is cyclical and periods of underperformance from investment managers should be expected so the structure should be such that when the market cycle is unfavourable for some managers it is favourable for others and vice versa. This is expected to deliver added value

over the long-term whilst smoothing the overall performance at the total Fund level. Churning of managers leads to additional costs; however, where the ISC no longer views an investment manager's prospects as positive over the long-term, action should be implemented as soon as possible due to the potential downside risk.

Appendix 2: Application of Core Investment Beliefs

In applying the investment beliefs to the wider LGPS, we would suggest that a 'comply or explain' criterion might involve setting out a clear justification relative to the following questions:

1. Is an investment consistent with the long term risk/return goals and strategic asset allocation of the fund? i.e.
    a. Is the expected return consistent with the fund's requirements?
    b. Is the time horizon of the asset consistent with the funds time horizon?
    c. Is the absolute risk level of an investment within tolerance levels?
    d. When combined with the existing portfolio, do total risk levels remain within tolerance levels?
    e. Is the liquidity of the investment consistent with cash/liquidity requirements of the fund?
    f. Are transaction costs/fees reasonable and is current market pricing attractive?
    g. Will the investment have a meaningful impact on the expected outcomes of the fund?

2. Should a CIV be used?
    a. Can the fund access the investment directly?
    b. Is a CIV with proven track record available?
    c. Will fees for the CIV (after taking account of transaction costs) be lower than alternative manager options?

3. Should an asset be managed actively or passively?
    a. Can the investment be managed passively?
    b. Will use of both active and passive management diversify specific risks within an investment?
    c. Are there attributes that I seek from an asset class that cannot be managed passively (high income for example)?
    d. Are there passive alternatives to active management which will give the same broad market exposures?
    e. Is a passive option available, but sub optimal (cash + mandates for example)?
    f. What might be the unintended risk of passive or active management (benchmark concentration, momentum bias in market capitalisation benchmarks etc)?
    g. Is there evidence that active management has consistently shown to be effective in this asset class and am I confident I can identify the attributes that led to that outperformance and select managers that exhibit them?
    h. Are there attributes of a market that I can manage passively, but would not want to (corporate governance in emerging markets for instance)?
    i. Are active management fees reasonable relative to the outperformance targeted and relative to industry peers?
    j. What are the appropriate constraints to apply to an active manager to allow scope to add value without overly increasing risk?
    k. Is there an understanding to assess manager performance over the long term and only make changes when necessary?