Nottinghamshire County Council

Report to Pensions Sub-Committee

6 November 2014

Agenda Item:8

REPORT OF SERVICE DIRECTOR – FINANCE & PROCUREMENT

LGC INVESTMENT SUMMIT 2014

Purpose of the Report

1. To report on the LGC Investment Summit 2014.

Information and Advice

2. The 26th LGC Investment Summit was held on 9 to 10 September 2014 at the Celtic Manor Resort, Newport. In accordance with prior approval and as part of the Fund's commitment to ensuring those charged with decision-making and financial management have effective knowledge and skills, the conference was attended by Cllr Sheila Place, Cllr Thulani Molife and Simon Cunnington (Senior Accountant – Pensions & Treasury Management).

3. ***Economic and market outlook***
The conference opened with a 'lively presidential style debate' focused on the fiscal and policy responses to the financial crisis. Josh McCallum (Head of Fixed Income Economics at UBS) claimed that central banks got the response wrong in the 1930s and 1970s, in both cases making the situation worse. He believed this to be the case for the recent Global Financial Crisis (or GFC as it was referred to by a number of speakers) where central banks had guessed how much quantitative easing (QE) to undertake. Kevin Barker (Head of Equities Capability Management at UBS) argued that the size of QE didn't matter – what was important was that decisive action was taken 'to put out the fire'. Without QE, there would have been another great depression.

4. Josh stated that inflation would eventually run out of control as the monetary base in the UK has tripled since the GFC and inflation was always caused by the amount of money chasing goods and services. Kevin countered by reminding that demand also plays a part and that currently there is very little demand. The real problem, he believes, is deflation. Josh believes that the UK is creating another bubble as QE and low interest rates fuel rises in asset prices with no sign of the promised manufacturing boom. However, this was because overseas customers were still in recession, claimed Kevin, and markets were still 30% below their peak in real terms.

5. ***Generating attractive returns with low risk***
Phil Apel, Head of Fixed Income at Henderson Global Investors and Alex Younger from the Norfolk Pension Fund gave a joint presentation on how active bond management can help to deliver returns. Real yields on US government bonds are usually around the level of GDP growth but have recently been much lower. In addition, bond indices are currently skewed

towards the biggest borrowers (ie governments) and so traditional bond investing is not best placed to earn returns.

6. The Norfolk Fund has an allocation of nearly 20% to bonds mainly for diversification but has been changing its mandates from largely gilts to focus more on absolute returns. These changes have been made in conjunction with the Fund's managers and are aiming to capture the benefits of the wide variation in returns from different types of bond investing.

7. ***New doors open in secure income as banks retreat***
John Dewey from Blackrock and Phil Ellis from Aviva Investors presented the case for alternative secure income investments. Bond yields are currently very low but bonds do provide predictable cash flows which are currently very important to the Local Government Pension Scheme (LGPS). Extra returns are also needed to increase funding levels but this involves higher risk. However, there are different types of risk which funds may be able to take advantage of such as illiquidity. It is possible to identify an optimal allocation to illiquid assets depending on the profile of the fund's cash flows.

8. Real assets can provide secure income. Traditional property mandates generally include at least 85% in offices, retail and industrial. Other assets such as farmland, timber and infrastructure can provide smoother and more predictable cashflows than index-linked bonds.

9. ***Emerging Markets: facts and fiction***
This session was presented by Scott Berg from T. Rowe Price. Emerging markets had high growth from 2000 to 2010 but since then have lagged developed market returns. In terms of company earnings, the US has recovered above pre-GFC levels but Europe and the UK haven't. Within emerging markets there is a clear distinction with Asia performing like the US and Latin America like Europe. It is important therefore to focus on individual companies and the sectors driving growth. Up to 2007, growth was driven by commodities; it is now being driven by IT, healthcare and consumers.

10. ***Are our investment management arrangements effective, efficient and responsible?***
The first day of the conference ended with a panel session to discuss the many topical issues regarding LGPS governance. The panel consisted of:
    - Chris Bilsland, former Chamberlain of the Corporation of London
    - Kieran Quinn, Chair of the Greater Manchester Pension Fund and LAPFF
    - Karen Shackleton, AllenbridgeEpic Investment Advisers
    - Mark Wynn, Head of Finance, Cheshire West and Chester Council

    A number of topics were covered and the key points are highlighted in the table below.

Common Investment Vehicles (CIVs)

Karen Shackleton	Need to be very clear on the objectives of a CIV as the most relevant structure may depend on this.
Chris Bilsland	The London CIV's main purpose was to work collaboratively, not necessarily save costs. Collaboration doesn't need to be done regionally; better to be between like-minded authorities.
Kieran Quinn	Raised concern over CIVs being presented as the only route forward. Better to broaden options available.
Mark Wynn	There is a real desire within the LGPS to collaborate. CIVs shouldn't just be about fee reductions – there are other ways to tackle fees.

Passive investing	
Chris Bilsland	Global funds all have mix of active and passive.
Karen Shackleton	Many active managers add value over the long term (ie 10 years plus). Need to research why funds change managers.
Mark Wynn	The LGPS is diversifying away its active returns by using 150 different managers. Maybe limit or require justification for the number of managers.
Kieran Quinn	Strong governance is the key element to driving returns. There is a clear negative impact from changing managers too often.
Active shareholders	
Kieran Quinn	This is a vital aspect of the LGPS with many funds increasing engagement. This may be harder to achieve with a pooled approach.
Chris Bilsland	Engagement may be easier with collective funds due to the weight of capital.
Mark Wynn	With a voluntary CIV, funds could require a responsible investment approach to be followed.
Infrastructure	
Chris Bilsland	Mergers were about getting access to funds for infrastructure. CIVs may work as it would give the required scale.
Karen Shackleton	Need to have a thorough debate on what infrastructure is aiming to do.
Mark Wynn	Local infrastructure investments may make sense but may need to have independence over the decisions.
Kieran Quinn	Why wouldn't funds invest locally if returns are right? But need good governance to ensure proper decisions are made.
How are funds managing liabilities?	
Karen Shackleton	Need to focus on the deficit and learn from the private sector by de-risking when possible.
Mark Wynn	One investment strategy isn't necessarily suitable for all employers in the fund.
Chris Bilsland	Funding levels likely to be healthier in the next 3 to 5 years.
The LGPS in 10 years?	
Kieran Quinn	Fewer funds through voluntary collaboration. Experience of the London CIV will drive change.
Mark Wynn	More employers and more mature funds. There will be greater collaboration.
Chris Bilsland	Several CIVs managing 80% of LGPS assets. All administration will be done collaboratively.
Karen Shackleton	Focus will be on income as all funds will be cash negative.

11. ***Can economic scale define your equity index?***
Vis Nayar from HSBC Global Asset Management presented an alternative to standard passive management. Most passive management uses cap-weighted indices on the theory that markets are efficient. However, in inefficient markets it is possible to use better alternatives. By looking at the difference between a company's inputs and outputs it is possible to measure value independently of the market.

12. A portfolio built on this basis can be rebalanced quarterly to take advantage of short term pricing errors. This approach tends to underperform during a bubble but then outperforms in the aftermath.

13. ***Controlling downside risk in equity portfolios***
Martyn Hole from Capital Group presented the benefits of companies paying dividends. Such companies tend to have better returns, and those that also consistently grow their dividends outperform in 80% of markets with significantly lower volatility. Companies that prefer share buybacks, however, perform less well as the timing of the buybacks tends to be poor.

14. John McLaughlin from Schroders discussed “downside protection”. He made the point that attempting to protect from falls in asset values always has a cost in terms of reduced returns. Therefore it is important to ask “is it worth it?” This really depends on the timeframe involved. Over the long term volatility isn’t a problem but over the short term, drawdowns can be large and so it may be worth paying a small amount for protection.

15. ***Top quality governance in your size***
The conference closed with a Hymans double act of Ronnie Bowie and John Wright who presented a comparison of LGPS funds’ funding levels and investment returns. This started by rebasing valuation outcomes on the Treasury assumptions which showed a general increase in funding levels from 2010 to 2013. However, the dispersion of funding levels was wide. There was no correlation of funding level to investment returns over the 3 year inter-valuation period but there was when a longer period (17 years) was used. This showed that small increases in returns can have a significant effect on funding.

16. Attention then turned to active management. Relative returns (compared to benchmarks) over 3 years ranged from -3.5% to +2.5% and over 50% of funds outperformed over that period. However, over longer periods (5 and 10 years) fewer than 50% of funds outperformed. There is little consistency in outperformance but there are a number of funds that had consistent underperformance. Addressing this will increase aggregate returns.

17. The conclusion was that every fund should have passive investments but a move to full passive investment would be a very bad outcome. The capacity to manage active investment properly depends on having strong governance in place.

Statutory and Policy Implications

18. This report has been compiled after consideration of implications in respect of finance, the public sector equality duty, human resources, crime and disorder, human rights, the safeguarding of children, sustainability and the environment and those using the service and where such implications are material they are described below. Appropriate consultation has been undertaken and advice sought on these issues as required.

RECOMMENDATION/S

1) That it be noted that attendance at key conferences is part of the Fund's commitment to ensuring those charged with decision-making and financial management have effective knowledge and skills.
2) That the report be noted

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Constitutional Comments

19. Because this report is for noting only, no Constitutional Comments are required.

Financial Comments (SRC 29/10/14)

20. There are no financial implications arising from this report.

Background Papers and Published Documents
Except for previously published documents, which will be available elsewhere, the documents listed here will be available for inspection in accordance with Section 100D of the Local Government Act 1972.

None