This matter is being dealt with by:
Simon Cunnington
Reference:
T 0115 977 2581
E simon.cunnington@nottscc.gov.uk
W nottinghamshire.gov.uk

Nottinghamshire County Council

Victoria Edwards
Department for Communities and Local Government
Zone 5/F5
Eland House
Bressenden Place
London, SW1E 5DU

10 July 2014

Dear Victoria,

Thank you for the opportunity to respond to the consultation on *Opportunities for collaboration, cost savings and efficiencies* within the Local Government Pension Scheme (LGPS). I am pleased to see that the Department has recognised that fund mergers should not be taken further at this stage.

The response to the consultation of the Nottinghamshire Pension Fund is attached. The key messages from our Fund are highlighted below.

- Common investment vehicles (CIVs) clearly have the capacity to enable fee reductions to be negotiated if sufficient funds are combined together
- However, the Nottinghamshire Fund is already low cost with an investment expense level of 0.1% of the Fund in 2012/13
- Part of the reason for this is in-house management which seems to have been overlooked in the consultation despite positive evidence within the Hymans report
- Oversight of the LGPS is currently very cost effective through the role of councillors
- CIVs will need to be resourced to an appropriate level to ensure effective governance
- Asset allocation should remain with local fund authorities
- Active management can add value, but only over the long term – for example Schroders have added at least £58 million to the Nottinghamshire Fund net of fees since 1999
- Returns net of fees are key – absolute fee levels are less relevant
- Other benefits flow from active management such as price discovery and effective engagement backed by the threat of disinvestment

The Nottinghamshire Fund would not be supportive of compulsion for all listed assets to be managed passively and would suggest that a “comply or explain” approach would be more appropriate. However, it would be far better to focus reform on analysis of the consistently high or poor performing funds and implement changes across the remaining funds to take advantage of any identified best practice. This would retain the outperformance from the better funds and help to improve the returns from the poor performers, thereby helping to reduce deficits across the LGPS.

Yours sincerely,

Councillor Stella Smedley
Chair, Nottinghamshire Pension Fund Committee

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.

Common investment vehicles (CIVs) clearly have the capacity to enable fee reductions to be negotiated if sufficient funds are combined together. The level of saving depends on the type of investment placed within the CIV and the current level of fees being paid – this will differ markedly by asset class and from fund to fund. The Nottinghamshire Fund has maintained a relatively simple structure for its traditional asset classes and has developed long term relationships with a relatively small number of external managers. The main portfolios are consequently of a significant size and fee levels have been kept low.

Total investment management expenses for 2012/13 for the Nottinghamshire Fund were £3.5 million on assets valued at £3.5 billion, an expense level of 0.1%.

One of the other key elements to the low cost of the Nottinghamshire Fund is having a significant proportion of the Fund managed in-house. It is surprising that the consultation is silent on the benefits of in-house management both in terms of cost and performance. The Hymans Robertson report commissioned by DCLG, however, has several useful reminders of the benefits of managing funds in-house.

‘Research carried out by CEM showed that the fee for an active EAFE (essentially global ex North America) equity mandate managed externally was over four times as much as an internally managed mandate (46bps v 10 bps)’.

(LGPS Structure Analysis, Hymans Robertson, 2013, p13)

‘There is evidence that internally managed pension funds in the UK have outperformed those with no internal management even before fees are taken into account’.

(LGPS Structure Analysis, Hymans Robertson, 2013, p18)

Table 11: Performance of internally managed funds (%p.a.) to the end of 2011 (before fees)

	5yrs	10yrs	20yrs	25yrs
Internal	3.7	6.2	8.6	8.9
All Funds	3.5	5.9	8.3	8.6
Relative	0.2	0.3	0.3	0.3

As the cost savings from using internal management are significant, the differential performance after costs are taken into account will be even more substantial.

(LGPS Structure Analysis, Hymans Robertson, 2013, p21)

The Nottinghamshire Fund has not invested in the majority of alternative asset classes but does have a significant commitment to a number of private equity funds. These are mostly fund of funds and secondary funds and so will include an additional layer of fees. This approach has been taken to increase diversification and because the necessary expertise was not available in-house. A CIV structure for direct investment into private equity may be an attractive alternative. However, using a CIV may bring a number of potential difficulties.

- Acquiring the necessary expertise within the CIV at reasonable cost
- Retaining access to smaller opportunities within the market
- Avoiding over concentration of investment

The first point above will apply to any CIV to be set up. To operate successfully, the CIV must be resourced appropriately to attract and retain the right staff with sufficient knowledge and expertise. Additional costs will also be incurred in the procurement, monitoring and oversight of the external managers appointed by the CIVs. These costs will be partly dependent on the location of the CIVs and the consultation provides no information in this respect. It is worth pointing out that the current oversight of the majority of LGPS funds is incredibly cost effective, being carried out for the most part by councillor “volunteers”.

There may be opportunities to reduce fees and access bigger projects (such as housing or other infrastructure) through greater collaboration between existing funds without the need to set up CIVs. There are also already examples of investment managers offering fee scales which reduce in line with the level of funds managed across the LGPS as a whole.

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

Asset allocation depends largely on the required return for the fund and its cash flow position which, in turn, depends to a large extent on the funding position and membership profile of the employers within the fund. As the consultation states (p7), ‘each fund has its own funding level, cash-flow and balance of active, deferred and pensioner members, which it takes into account when adopting its investment strategy’. Clearly, therefore, asset allocation decisions should be retained by the local fund authorities.

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?

One of the main tenets of investment is diversification, spreading investment across multiple asset classes and managers to reduce the risk that all perform poorly at the same time. This would apply in the same sense to CIVs. It would be counter-intuitive to set up only one CIV as this would increase the impact if the CIV’s decisions turned out to be detrimental to performance. However, creating more than one CIV clearly increases the cost of implementation and ongoing operations.

The number of CIVs required may be partly dependent on the outcome of the consultation on proposal 2 regarding the passive investment of listed assets. If all listed assets are required to be managed on a passive basis, then one CIV may be able to place these assets with one or more of the major managers of passive mandates with relatively little increase in risk. However, if a significant proportion of assets remain actively managed, then funds will need to be spread over a number of managers to reduce the risk of concurrent underperformance. This may be better managed through more than one CIV.

Another issue may be capacity to trade. If only one CIV is used, then asset allocation changes by funds may result in sizeable trades which could distort the market. This would be reduced if more than one CIV were used. The difference in the quoted net present value of savings from assets pooled into two CIVs or ten is relatively small so the ideal number of CIVs would fall somewhere in between.

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

It is difficult (if not impossible) to comment on which CIV would offer the most beneficial structure without having done in-depth analysis of costs, benefits and drawbacks of the different types available. It may be sensible to use the analysis presumably carried out by the London Councils when setting up the London CIV to determine what would be the most suitable structure.

Although Hymans Robertson were asked to focus on “hard” benefits such as cost reductions rather than “soft”, less easily quantifiable benefits, the consultation does recognise that there are benefits from improved governance (p14). It would be expected therefore that CIVs set up as part of any reform of the LGPS would strive to reflect best practice in governance. To do this they will need to be properly resourced and have officers and board members with sufficient expertise of both investment and governance matters. This may reduce the cost savings achievable as pointed out above.

A key role of the CIV will be monitoring and oversight of external fund managers. One of the strengths of the Nottinghamshire Fund is the long term relationships it has with its investment managers and this would be lost through a CIV as there would be no direct contact between the Fund and those managing its assets.

The Nottinghamshire Fund, along with many other LGPS funds, already strives for best practice in its governance by seeking to comply with guidance prescribed by the Secretary of State and issued by CIPFA. This is borne out by the performance of the Fund as the table below demonstrates.

Fund returns achieved over 1, 3, 5 and 10 years

To 31 March 2013	**1yr** %	**3yrs** %pa	**5yrs** %pa	**10yrs** %pa
Total Fund	13.9	8.2	6.3	9.0

Particularly interesting to note are the 3 year returns (8.2% pa) which are comfortably ahead of the assumed returns (6.9% pa) at the 2010 triennial valuation, and the 10 year returns (9% pa) which are well ahead of the assumed returns at any of the last four triennial valuations. This demonstrates clearly that investment returns, far from causing an increase in deficits within the Nottinghamshire Fund, have actually helped to mitigate the increasing liabilities caused by reducing bond yields and increasing longevity. A full understanding by those in government of the nature of a funded scheme, including the triennial valuation process and the real causes of deficits, would be beneficial in framing proposals for reform.

Proposal 2: Passive fund management of listed assets

The Government 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 LGPS, in common with the whole of local government, is constantly adapting to become more efficient and seeking ways to collaborate between funds. Having local councillors as "trustees", means that there are few additional costs involved resulting in a very cost effective system. The investment of funds and the approach to funding is done with a long term viewpoint in order to minimise the variability in employers' contribution rates. This all helps to secure value for money for taxpayers.

The consultation recognises that it is important not to adversely affect investment returns as returns contribute significantly to reducing the cost of the scheme to employers. However, there are a number of flaws with the information provided within the consultation and the supporting report from Hymans Robertson.

The consultation claims that the proposal to move the management of all listed assets to a passive basis will save £420 million, of which £190 million is in reduced transaction costs. However, transaction costs have the effect of increasing the purchase cost of assets and reducing the proceeds of sales and are therefore reflected fully in the returns quoted – the returns are in effect shown net of these costs. Care must be taken not to double count these "savings".

Returns net of fees should be, in fact, a key focus of the consultation. If returns after fees are ahead of benchmarks or performance targets, the absolute cost of investment management is less relevant. There is clearly no guarantee that managers will exceed their benchmarks and the Hymans report presents evidence that the LGPS in aggregate doesn't. However, the report also states that 'a number of LGPS funds have a good and consistent record of investment performance over long periods' (p20).

In order to improve the aggregate performance of the LPGS there should be a focus on both the consistently high performers and the consistently poor performers. The reasons why these funds consistently perform well or poorly should be examined and changes implemented across the remaining funds to take advantage of any identified best practice. This will enable the existing outperformance to be retained while helping other funds to improve their returns with a consequent effect of deficits. Bringing aggregate performance down to the average will only increase deficits.

The explanations of performance are likely to include:

- Quality of governance and decision making
- Appropriateness of asset allocation and frequency of revision
- Whether funds adopt a genuine long term approach
- Number of managers and complexity of investments
- Frequency of manager changes

The Nottinghamshire Fund has a mixture of passive and active investments. The In-house portfolio includes mainly passive equities, managed both in-house and by external managers such as Legal & General. The Fund's two other main managers of listed assets are Schroder Investment Management (equities) and Kames Capital (bonds) – both manage assets on an active basis. The gross performance of these portfolios is shown below for periods up to 31 March 2014 and compared to both the benchmark set for the portfolio and the Fund's strategic benchmark for the asset class.

	3 months		**12 months**		**3 years**		**5 years**	
	Portfolio %	**B/mark %**	**Portfolio %**	**B/mark %**	**Portfolio %**	**B/mark %**	**Portfolio %**	**B/mark %**
In-house	0.1	0.0	7.3	6.5	7.7	7.3	15.3	14.9
Schroders	-1.3	-0.1	10.5	7.9	8.8	7.9	16.6	15.5
Strategic Equity B/mark		**0.5**		**6.8**		**7.7**		**14.9**
Kames	2.4	2.2	-2.5	-1.6	6.1	6.1	6.3	5.9
Strategic Bond B/mark		**2.1**		**-2.6**		**5.5**		**4.5**

This demonstrates two things:

- performance, particularly of the active managers, is volatile
- over the longer term, active managers can perform well in both absolute and relative terms.

There is no doubt that returns from active management are volatile and that hiring and firing of managers is often flawed. However, by taking a long term view of performance and closely monitoring managers' activities it is possible to ride out this volatility to achieve significant returns net of fees. For example, analysis of Schroders' performance since 1 April 1999 (the earliest data available) shows that they have added at least £58 million to the Nottinghamshire Fund in excess of fees. This has helped the funding position and is something the Fund would not wish to lose.

The Nottinghamshire Fund uses passive investment for equities because it believes that long term returns from equities will exceed returns from other mainstream assets. It therefore wants exposure to this asset class at reasonable cost and relatively low risk. This approach would not necessarily be suitable for bonds, however, where the role of the active manager is partly to avoid companies that may be at risk of default.

The Fund is also committed to long term responsible investment and recognises that engagement with companies in which it invests is important. However, on occasions, it will be the best course of action to reduce a holding or disinvest entirely from certain companies. This also helps "price discovery" which should ensure that a company's share price better reflects its future prospects. The direct impact on performance and the wider benefits to the market of this approach may be difficult to achieve if all investments are managed on a purely passive basis.

We would not, therefore, be in favour of compulsion in moving all listed assets to passive management and would suggest that a "comply or explain" approach would be more appropriate.

Respondents to this consultation are also invited to submit any feasible proposals for the reduction of fund deficits.

There are no proposals which will guarantee a reduction in fund deficits (which may explain why there were few suggestions submitted to the call for evidence). The important issue is to realise that the triennial valuation is about the long term funding of the scheme (and in this sense long term means 70 years or longer) not about trying to achieve full funding in 3 years. We therefore reiterate the points we made in our response to the call for evidence.

It is necessary to change the triennial valuation priorities to focus on a fund's real ability to pay pensions over the short, medium and long term. Focusing on one liability figure, affected hugely by the assumptions within the discount rate, is unhelpful and creates unnecessary concern.

The problems are compounded by the use of International Accounting Standard 19 (IAS19 Employee Benefits) for reporting pension liabilities. The treatment and reporting of an employer's pension liability as if it were a trade creditor due to be paid within 30 days is wholly inappropriate for pension benefits payable over decades.

It is also important to note that deficits are estimated and, because the cash flows involved are over a considerably long time, the biggest impact comes from the discount rate used by the actuaries. Sensitivity analysis carried out by the actuaries shows that, for Nottinghamshire, a movement of just 0.1% in the discount rate changes the fund's liabilities by over £100 million. As one of the main components of the discount rate, increasing bond yields could, at a stroke, wipe out the deficit. Across the LGPS as a whole, such movements in liabilities would far outweigh any cost savings that can be achieved through the proposals in the consultation.

As a long term investor, volatility of returns and funding levels should not be a problem as long as cash flows overall remain positive and attitudes to the long term funding of the scheme at each triennial valuation are pragmatic and reasonable. This unfortunately is often not the case as this consultation shows. A misunderstanding of what affects the valuation of liabilities, and the consequent deficits (or surpluses), runs the risk of implementing changes which reduce the long term returns achieved by the scheme as a whole. This will increase deficits rather than reduce them.