Nottinghamshire County Council

Report to Pensions Sub-Committee

7 November 2013

Agenda Item:4

REPORT OF SERVICE DIRECTOR – FINANCE & PROCUREMENT

LGC INVESTMENT SUMMIT 2013

Purpose of the Report

1. To report on the LGC Investment Summit 2013.

Information and Advice

2. The LGC Investment Summit 2013 was held on 4th to 6th September 2013 at the Celtic Manor Resort. 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 Parry Tsimbiridis, Mr Chris King and Simon Cunnington (Senior Accountant – Pensions & Treasury Management).

3. ***Local economic influences***
The conference began with Paul Johnson, Director of the Institute for Fiscal Studies, giving the economic background to the financial crisis and the outlook for the future. The UK's GDP is still below the 2008 level and, although employment levels have now recovered, output has collapsed meaning that productivity is still 12% lower. The Office for Budget Responsibility is now forecasting weak growth in 2013 with up to 2% growth in 2015. Consensus forecasts are better for 2013 with 2% growth for the next 4 years indicating higher levels of optimism. In 2010, public sector borrowing was forecast to be under control by 2015/16. However, the last 3 years have seen no reduction (due to low growth) and forecast now goes beyond 2017/18. This means that significant cuts are still to come.

4. ***Pension fund perspective on LGPS 2014***
Jonathan Bunt (LB Barking & Dagenham) gave some background to their fund and outlined his views on the impact of the new scheme. The fund is about £650m with liabilities of £950m. Active members increased in 2012/13 but those paying higher contributions reduced (particularly as a result of sharing senior managers). However, cash flow modelling of the new scheme suggests an extra £300,000 in contributions.

5. He then went on to give views on the proposals of fund mergers, suggesting that the evidence can be used to argue both sides. The London debate is not as polarised as portrayed in the press with most agreeing that the current structure is not sustainable. Management fees are not as important as made out but reporting

performance net of fees would aid comparability. He ended by emphasising the importance of bond yields in dealing with deficits, stating that a change of 0.5% in yields would change their liabilities by £75m.

6. Geik Drever then outlined the position of the West Midlands Pension Fund (a £9.9 billion fund with a funding level of 75%). Despite the new scheme, she expects the funding level to reduce at the latest valuation with a consequent rise in employer contributions. The LGPS 2014 will increase the administrative burden but the Scheme Advisory Board and the involvement of the Pensions Regulator will bring an even higher level of confidence in governance. She is, however, predicting further scheme changes before 2020.

7. In relation to proposed fund mergers, she made the point that most funds already operate a shared service as they provide pensions for multiple (and increasing) employers. Affordability and sustainability are of prime importance.

8. ***Smarter exposure to global equities***
This session allowed two investment managers to explain how they approach global equity investing. First was Ben Kottler (MFS Investment Management) whose approach is to focus on companies' revenue streams rather than domicile. For well-known brands, over 50% of revenues are generated outside the country of domicile. Across the MSCI AC World indices, about a third of revenues are generated outside of each region. This is particularly marked in Europe where poor domestic growth encourages an export economy and where some stock markets actively encourage foreign companies to list.

9. Mikhail Zverev (Standard Life Investments) claimed that most investors use very high level information when selecting stocks. This has been driven by the "risk on, risk off" attitude since 2007 and the growth of Exchange Traded Funds (ETFs) and global macro investment approaches. This, he argues, gives great opportunities for "stock-pickers" who can focus on stock specifics.

10. ***N-50: the next generation of emerging market opportunities***
In the first of two break-out sessions, Nick Davidson (AllianceBernstein) put forward the opportunities available in what he termed the N-50, the next 50 emerging markets. These are spread across Africa, South America, Eastern Europe and Asia although not all are classed as investible yet. Traditional emerging markets are becoming more correlated with developed markets. The N-50 are less correlated and expected to be less volatile. However, liquidity is low and most "frontier indices" do not include sufficient stocks. This means management has to be active and focused on long term returns (expected to be 13-15% pa).

11. ***Finding the best opportunities across fixed income markets***
In the second session, Iain Lindsay (Goldman Sachs Asset Management) outlined the prospects for fixed income. Over the last 10 years, the 10-year gilt yield has reduced from 4.5% to 1.5%. Therefore bond returns have been good (although not so good for funding levels). This seems to be changing, with the yield at that stage up to 3% and rising. Bond returns are heavily influenced by interest rate movements and investment has traditionally been made on this basis. However, it

is increasingly important to be more flexible and dynamic taking into account both macro and stock specific data as well as views on rates and currency.

12. ***Making the best investment choices at the right time***
The first day concluded with a panel session comprising Emily McGuire (Aon Hewitt), John Harrison (Independent Adviser) and Georgina Taylor (Invesco Perpetual) and chaired by Nicola Mark (Norfolk Pension Fund). A summary of the discussions is shown below.

Current asset allocations	
Emily McGuire	Figures from WM show an average allocation to equities of 63% with 80% overall in growth assets. There is a trend from equities to alternatives which is good.
John Harrison	The only available option to deal with deficits is to improve investment returns. Equities are a good, cost-effective way of generating long term returns. Need to be wary of inflation though.
Georgina Taylor	Need to test portfolios and look at the drivers of different asset classes and the correlations between them.
What should we have done differently 10 years ago? Any top tips?	
John Harrison	On the whole, local authorities did reasonably well by not moving out of equities. Could have been a bit quicker moving into emerging markets and should have focused more on liabilities. Top tips – focus on things which mean will have to pay out more (eg inflation) and be ready for de-risking as funding levels improve.
Georgina Taylor	It is important to challenge beliefs and most funds underestimated globalisation. Top tips – be wary of the exposure of equities particularly via indices.
Emily McGuire	Funds needed to evaluate decisions more and have governance systems in place to enable quick decisions. Top tips – examine balance between developed and emerging markets with a view to increasing weighting to emerging.
LGPS Restructure Proposals	
Georgina Taylor	It is important to think about unintended consequences of changes such as the possibility of encouraging more passive investment.
Emily McGuire	It is returns net of fees which are important in reducing deficits. Fees tend to reduce with mandate size but only marginally with mandates above £100m. Savings are therefore unlikely to be as big as forecast. Collaboration has an important role to play.
John Harrison	Those without knowledge of the LGPS believe that bigger funds mean lower fees and better returns and therefore some consolidation is probably inevitable. Cost savings can be big in money terms but are a small proportion of deficits and transition costs could outweigh savings for many years. In general, over-complexity costs more.

	The call for evidence was more a ‘call for affirmation’.
What should funds not be doing?	
Emily McGuire	Don’t ignore liabilities.
John Harrison	Don’t buy gilts. Don’t follow fashions. Don’t overpay for performance.
Georgina Taylor	Don’t look back. Don’t ignore equity exposure.

13. ***De-risking but where to and where from?***
Mark Parry (Aberdeen Asset Management) began day two by discussing diversification. This is generally accepted as a good idea but how should it be implemented? Stock markets have become increasingly correlated and have tended to move together in times of stress. His approach is through diversified growth, investing in a number of different asset classes but limiting the amount in each. The investments available now are much wider than in the old balanced funds and include infrastructure, cash, options and gold.

14. Nicholas Gartside (JP Morgan Asset Management) predicted that global bonds will outperform equities over the next 5 years. Fixed income benchmarks have been skewed by the transfer of debt from private to public and by concentration into a few corporate names. Neither of the two enemies of bond returns (rising interest rates and inflation) is currently present but it will be important to watch wage inflation. High yield bonds will be driven by the default rate and this is expected to remain low. The key to investing over the next 5 years will be to customise benchmarks, use indices better and reduce managers’ constraints.

15. ***But how will it all help the valuation outcomes?***
Ronnie Bowie (Hymans Robertson) used his traditional conference closing slot to give his views on the outcome of the current valuation and the proposed fund mergers. The current valuation is expected to result in slightly reduced average funding levels but with significantly higher cash deficits. The notion that fund mergers would help reduce these deficits was described as ‘nonsense’.

16. ‘Cashflows are king’ and the combination of contributions and investment income means that most funds can still invest for the long term. He stated that there is no correlation between size of fund and returns giving the example of four funds ranging from £300m to £8 billion with the same 5 year returns. However, larger funds tend to have less variance in average returns and may better be able to access more difficult asset classes such as private equity.

Statutory and Policy Implications

17. 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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Background Papers
None