Nottinghamshire County Council

Report to Pensions Sub-Committee

5 November 2015

Agenda Item:9

REPORT OF SERVICE DIRECTOR – FINANCE & PROCUREMENT

LGC INVESTMENT SUMMIT 2015

Purpose of the Report

1. To report on the LGC Investment Summit 2015.

Information and Advice

2. The 27th LGC Investment Summit was held on 10 to 11 September 2015 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 Reg Adair, Cllr Sheila Place and Simon Cunnington (Senior Accountant – Pensions & Treasury Management).

3. ***A guide to markets***
   The conference began with an economic viewpoint from Stephanie Flanders (currently with JP Morgan Asset Management but formerly with the BBC), who outlined five key messages:
   - Volatility will continue
   - Emerging and developed markets are diverging
   - The key question on rate rises is pace not start date
   - The European Union will survive but could be performing better
   - Diversify more but expect lower returns

4. Volatility may be a good sign that markets are returning to normal as quantitative easing (QE) is removed. The recent market falls are nothing out of the ordinary (the average fall over a year in the UK is 12%) and years with big falls can still produce decent returns. The issues in China during August were expected but there are still questions over the real economy and the ability of the Chinese government to manage it. Emerging market economies have been weaker than expected with growth mainly coming from developed markets. Productivity and real wage growth are both growing and this may point to a rise in interest rates. However, the pace of increase is likely to be slow after the first rise.

5. Demand for borrowing is up in the Eurozone but it is mostly consumer and household debt rather than corporate. The European Central Bank will continue to support the economy but earnings estimates are finally improving in Europe. Most markets are back to their long term price/earnings averages but emerging markets are now below this level. However, it is possible that they could get cheaper still.

6. ***Addressing the funding challenges of pensions – extending the asset allocation mix***
Declan Canavan (also from JP Morgan) picked up the theme of diversification. He asked whether equity markets and bond yields were at an inflexion point (the former likely to go down, the latter likely to go up). If so, there will be increased volatility and lower returns. Therefore funds need a strategic allocation to alternatives.

7. Alternatives give different benefits – some increase diversification (hedge funds, real assets), other increase returns (private credit and equity). Real assets (such as property and infrastructure) should have some inflation protection and should be able to take advantage of the illiquidity premium. Private credit has taken off since increased banking regulation. Growth is expected to come from smaller companies but sustained interest rate rises may hamper this and lead to an increase in defaults. Private companies are staying in private ownership for longer and so more of the returns will be earned through private equity than the public markets. However, there is a wide dispersion of returns in private equity funds so finding the right managers is key.

8. ***Achieving returns more cost effectively and efficiently***
The next session began with Kal Ghayar from Goldman Sachs Asset Management who explained "Smart Beta". The Dow Jones Industrial Average began in 1896 and even today, market indices are still largely based on the market capitalisation of companies. This, however, has the effect of skewing company weights within an index in periods of stock market bubbles.

9. Owning all companies in an index will produce market returns (known as beta). Excess returns above the market are known as alpha. This is usually thought to come from manager skill in selecting stocks that outperform. However, a portion of the excess return is derived from certain factors. Five factors are 'explainable and deliverable':
    - Value
    - Size
    - Momentum
    - Volatility
    - Quality

10. Smart Beta (which is the fastest growing area in investment management) aims to use some or all of these factors to enhance returns without requiring a traditional active manager's fee. Some strategies use one or two factors but a better outcome may be achieved from a diversified factor strategy.

11. Mark Phelps from Alliance Bernstein defended the active manager's corner by talking about concentrated portfolios. The benefits of diversification within a portfolio become incremental after about 20 stocks and managers with a concentrated portfolio and high "active share" (the percentage of stocks held that differs from the benchmark) have outperformed broader managers. Mark claimed that these portfolios perform better in down markets as the manager tends to know each company very well and focuses a lot of effort on the potential downside.

12. There are constraints in managing concentrated portfolios as the manager will be taking fairly large positions away from the benchmark. A suggested approach is to split the equity allocation between passive (75%) and concentrated active (25%).

13. ***Flash reports***
Rachel Dalton, Features Editor of the LGC, shared the results of a recent survey of 51 funds on Local Pension Boards.

Benefits	75% said there were benefits from having a Pension Board but some had reservations
Appointment process	A number of different ways of appointing reps but most involved an interview. Getting interest was generally a problem.
Unions	58% have official union representation
Joint Committee/Board Shared Boards	Only one has been approved so far 3 shared boards have been set up
Meeting frequency	1/3 of boards meet twice a year 1/2 of boards meet four times a year 1 board meets 5 times a year

14. Jeff Houston from the LGA then gave an update on the government's announcement on pooling investments. The criteria against which options will be assessed are likely to be published in the autumn and will be around size, cost and governance. Size and cost savings will not be specifically quantified but will have to be "significant".

15. The back stop legislation is likely to give scope to the secretary of state to take action on funds that do not come forward with pooling options. There is no fixed idea of structure at the moment but the government will be looking for a combined message rather than a large number of separate submissions. The outcome is likely to be announced in the spring of 2016, possibly as part of the budget.

16. ***How to achieve funding targets***
This session began with Phil Triggs, from Surrey Pension Fund, who discussed the deficit across the LGPS at the 2013 valuation. The total assessed deficit was £47 billion but assumptions varied widely between funds. Using a standard discount rate of CPI plus 3%, the deficit would have been £27 billion. At the 2016 valuation, standard assumptions will be used across the scheme as a comparator (individual fund's will still set their own assumptions for determining employer contributions).

17. There are three ways to improve funding:
    (a) Increase contributions
    (b) Improve investment returns
    (c) Manage liabilities

    One way to help with (a) and (c) is to undertake employer risk analysis. Some funds have employer specific deficit recovery plans or even separate employer discount rates. Liability Driven Investing (LDI) can also help, particularly if the discount rate is based on gilt yields.

18. Georgina Taylor from Invesco Perpetual then discussed the increased correlation of markets since the financial crisis. Global bond and equity markets are more correlated and so, to find diversification, it is necessary to delve deeper into the factors driving markets. Georgina used the example of currencies in Japan and Korea (the former having been devalued over time to make goods cheaper). These differences can generate uncorrelated returns.

19. ***The power of active management***
This session was presented by MFS Investment Management. Madeline Forrester began with the results of a survey undertaken to assess views of active management. UK respondents are predicting a bigger decrease in active management than European counterparts and have a lower level of belief that active managers are worth the fees they charge. It was suggested that this implies a skewed focus on cost in the UK, perhaps as a result of the recent government interventions.

20. Michael Cantara then argued that active management has demonstrated added value over time. Although on average, active managers have not outperformed the market, no-one is looking for average. Top quartile managers have outperformed over multiple asset classes. The majority of excess return comes from longer holding periods and high active share (in essence having high conviction in the companies in which they are investing). Opportunities for active managers can come from increased short-termism from other market participants, greater volatility and more complexity.

21. ***Flash report***
Julian Pendock from the London CIV outlined progress so far in creating a collective investment vehicle for 31 London Borough funds. A chairman, Lord Kerslake, has been appointed and an application submitted to the Financial Conduct Authority. Oversight of the CIV is by a joint committee made up of representatives of each participating authority. There is also an investment advisory committee attended by s.151 officers. The CIV will include both active and passive managers and first invested assets are expected in the autumn.

22. Setting up the CIV has been time and resource intensive as there is a lot of compliance, due diligence and monitoring undertaken. However, the CIV is not just a procurement exercise but rather a full service fund management entity with the potential to offer in-house management in future.

23. ***Information exchange***
Day one of the conference closed with separate discussion sessions on four themes:
    - Asset allocation
    - Investment regulations
    - Proposals for separation of control
    - Pooling investments to reduce costs

24. ***Optimum returns from asset allocation strategies***
Day two began with Nick Vickers, Head of Financial Services at Kent. The reality of the LGPS is that it has strong returns and low fees. Each fund does some things well and some things not so well and it is consequently difficult to impose one approach across the board.

25. Strategic asset allocation has changed over the last 20 years but there has been an element of “herd instinct”, particularly where consultants have been used. To be otherwise needs strong internal expertise and decision making. Tactical asset allocation can add value but only within a stable, long-term approach. It is also important to recognise that it is impossible to get every decision right. Kent has been a long time investor in property (currently about 14% of the fund) and tactical decisions to add to the allocation at times have added value. Returns have been 10.8% pa over 20 years.

26. Christopher Mahon from Baring Asset Management outlined their forecasts for future returns. The current ten year return forecasts are all below 8% pa as they are largely based on assumptions over demographics and productivity. The US is predicted to have a slowing of productivity and population growth and consequently capital value falls are expected in US equities. Bond yields are being kept below nominal GDP growth as a result of "financial repression" (as banks and pension funds are forced to own more bonds than they would otherwise want). This information can be used to inform asset allocation decisions.

27. ***Flash report***
Alison Scott from CIPFA gave a brief update on the outlook for public finances. Cuts to public expenditure are expected to continue following the 2015 budget. The percentage allocated to protected departments is increasing thereby placing greater pressure on the rest. Cracks are beginning to appear in local government as a result. Council tax and business rates are now seen as outdated and the 2015 spending review is expected to look for more collaboration and devolution, with more changes to how services are delivered.

28. ***The search for additional yield to restore funding levels***
Christian Howells from Aberdeen Asset Management made a case for an alternative approach to asset management. Over the last 40 years, investors have changed their view of active management from involving pure skill to looking for the sources of return. The increased correlation since the financial crisis has caused investors to look for "diversification of underlying return drivers". This, however, introduces hugely increased complexity and so investors need "solution providers" to implement strategies.

29. Mat Dawson from Warwickshire County Council argued that we need to get used to higher volatility and lower returns and, therefore, need alternatives to add either extra return or additional diversification. However, cash flow considerations also mean that there has to be an element of flexibility. For this reason, alternatives need to be customised to each fund's circumstances and this may be difficult via collective investment.

30. ***Prepare to be consulted?***
The conference ended with Chris Bilsland, Adviser to the Scheme Advisory Board, outlining a number of the Board's key priorities. He started with the government's call for pooling investments but emphasised that the Board's role is to advise the government on the potential benefits and drawbacks of options put forward (rather than suggest options itself). However, he did state that vehicles such as the London CIV are probably the most robust and sustainable solution.

31. Another current workstream is the consideration of greater separation between LGPS funds and their administering authorities. Three options are being considered:
    - Stronger role for s.151 officers
    - Joint committee (not just of the administering authority)
    - Separate public body

32. The Board is also aiming to be more involved in communications around the 2016 valuation. At the last valuation, the scheme deficit was £47 billion but standardised assumptions from the Government Actuary's Department would have produced a deficit of £24 billion. These assumptions will be used as a comparator this time and national communications will be co-ordinated by the Board. Funds will continue to use their own assumptions, however, to set funding levels and employer contributions.

33. The conference proved to be a very timely opportunity to keep up to date on the many ongoing proposals for change within the LGPS and a useful opportunity to discuss possible responses with representatives from other funds and external service providers.

Statutory and Policy Implications

34. 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

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

Financial Comments (SRC 21/10/15)

36. 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