Nottinghamshire County Council

Report to Pensions Sub-Committee

22 July 2014

Agenda Item: 7

REPORT OF SERVICE DIRECTOR – FINANCE & PROCUREMENT

NAPF LOCAL AUTHORITY CONFERENCE 2014

Purpose of the Report

1. To report on the NAPF Local Authority Conference 2014 held in the Cotswolds.

Information and Advice

2. The NAPF Conference 2014 was held on 19th to 21st May 2014 at the Cotswold Water Park Four Pillars Hotel in Gloucestershire. 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 Councillor Ken Rigby, Councillor Thulani Molife and Mr Nigel Stevenson (Group Manager – Financial Strategy and Compliance). The theme of this year's conference was The Changing Shape of the LGPS.

3. ***Learning Zone 1 – Demystifying Common Investment Vehicles***
The conference commenced with a number of learning zone sessions, which began with Julian Brown, Director of Investment Consulting, JLT Benefit Solutions giving a presentation providing his views of the issues to LPGS investing in common investment vehicles (CIVs). He started by setting out the significance of the investment decisions made by pension funds on financial performance, namely that strategic asset allocation was the most significant with selection of the fund manager being the least significant. He reiterated the Government's consultation documents which showed their drive to pursue CIVs for passive management of listed assets and alternative assets. Julian's view was that at the strategic level the use of CIVs is self-evident best practice. However, the devil is definitely in the detail, including, determining who would run them, how their performance objective would be defined and how flexible will they be. There are a lot of very important details that are missing when considering if CIVs are the best approach and there are definitely some asset classes that are not suited to CIVs, e.g. corporate bonds, listed property. Julian also identified a large number of significant risks with CIVs, in particularly with the 'alternatives' CIV, e.g. liquidity, price volatility, flexibility, governance etc.

4. ***Learning Zone 2 – A case on managing liability risks***
Tracey Milner, AXA Investment Managers, introduced this session with a brief look at the common misconceptions regarding pension risks. Her view was that the common perceived largest risk for pension funds appears to be 'Active' risk;

the risk that a fund or managed portfolio will (or not) beat the returns of the benchmark; followed by 'Asset Mix' risk; the risk of change in total market value of the asset portfolio; and then the 'Liability' risk; the risk of change in total market value of liabilities. Whereas in reality it is the 'Liability' risk which is the greater risk; including interest rate, inflation and longevity risks.

This was followed by a case study presented by Mathew Trebilcock, Pension Investment Manager, Cornwall Pension fund, explaining Cornwall's strategy in trying to manage the liability risk. Recognising that inflation represented a significant risk to the Fund, and attempting to address this risk to limit rises in long-term contribution rates, they decided to hedge inflation independently from hedging interest rate risk. Their plan involves hedging up to 20% of their inflation linked liability risk, initially with £50m. This would involve a complex investment vehicle, known as a Qualifying Investor Fund (QIF), using derivatives in various forward swap arrangements in gilts or other inflationary swap instruments.

Julian Brown then explained JLT Benefit Solutions' role in supporting Members of the Cornwall Fund understand liability risk and suggested the idea of liability hedging.

Jonathan Crowther, Head of UK Liability Driven Investments, AXA Investment Managers, followed to explain AXA's approach in supporting Cornwall to hedge against the CPI risk. This involved deconstructing Cornwall's liability cashflows and, as there is no market for hedging against CPI, an equivalent RPI model had to be agreed upon as well as agreement on the benchmark and timeframe. Jonathan went into the details of the strategy for managing the fund and the strategy for increasing the hedge up to 20% of liabilities.

5. ***Learning Zone 2 – Infrastructure – minimising risk and maximising returns***
Boe Pahari, Managing Director, Head of Europe and the Americas, AMP Capital, led the session focusing on global investment opportunities in infrastructure assets offering low-risk, robust cash yield and capital growth. His presentation began by explaining that 51% of global infrastructure investment deals were in Europe, particularly UK, Nordics, and South & East Europe with the main focuses on transport, utilities and communications. A considerable amount of this infrastructure investment in Europe was by Canadian and Australian Pension Funds. In North America most of the infrastructure investment was in power and energy sectors.

Boe set out the 3 areas of infrastructure investment opportunities:
a) Social – typically housing, education, hospitals, that were small lots, lower risk, a lot of effort but offers poorer returns
b) Economic infrastructure – typically gas distribution, electricity, water, airports, toll-roads, ports, telecoms etc., accessed through pooled funds, with high risks and better returns
c) Greenfield assets – new projects which are approaching or under construction which are very high risks but even better returns.

Boe then explained the approach taken by AMP Capital when investing in infrastructure which included investments in Newcastle Airport, Thames Water and Angel Trains in the UK and Alpha Trains in Continental Europe. His Fund would take a significant equity stake in all investments, typically 40%, that provided at least negative control and board representation. This enables his investment team to pursue an active, hands-on approach to the management of the company. They will appoint board directors with CEO-level industry experience, building in best-in-class management. His Fund placed a strong emphasis on driving efficiencies and implementing strategic growth initiatives that delivered long-term value for investors. His investment team continually reviews the market conditions to maximise investor returns through an optimal exit strategy and timing, through a range of strategies such as negotiated sale, auction of initial public offering (IPO).

He finished his presentation with the hard sell of a 10 year global infrastructure fund offering targeted returns of 12-15%, with a cash yield of 4-6%

6. ***Joanne Segars, Chief Executive, NAPF***
   The main conference began with Joanne Segars welcoming everyone to the 10th annual event and setting the tone from the brief history of the set-up of the LGPS to the vast array of Regulations that has shaped the LGPS. She indicated that we now find ourselves in a period of more rapid change; with the scheme changes implemented in April 2014 (CARE), the proposed changes to governance from April 2015, the work undertaken on the 'call for evidence' and fund mergers review and the recent announcement and consultation on proposed solution to find savings in investment management fees.

7. ***LGPS 2014: a safe delivery?***
   The new scheme was 49 days old and this session concentrated on the issues in preparing for the new scheme.

   David Anthony, Head of Pensions, Wiltshire Pension Fund, provided an insight on Wiltshire's experience of preparing for the new LGPS in the run up to April 2014. In addition to a proper resourced implementation plan the main theme was communication; which began as far back as March 2011. This involved working with Employers, Unions, Councillors and scheme members; providing presentations, roadshows, clinics, newsletters, changes to the website and printed materials. It also became apparent through the question session that although they had an upgrade to their administration system, this had not been as successful as hoped for and a number of manual calculations are required outside of the system. A further upgrade is planned in the summer.

   Mike Allen, London Pensions Fund Authority, echoed the presentation given by David, with a similar tale of the LPFA preparations for the new LGPS. Mike also alluded to the issue of the lateness of the regulations which also caused issues with overall preparation but in particular that for the software suppliers. They too have issues with their administration system and are awaiting fixes. Mike also indicated that there has been an increase in the number of questions raised regarding how the LGPS is addressing deficits which probably records a success as far as the communication strategy is concerned.

During the end-of-session questions both Mike and David were asked about what were the greatest challenges to these changes. This appeared to be getting employers on board regarding providing the information that is now required and training the administration team due to the lateness of the regulations. Both indicated that the implementation of the new regulations had resulted in additional costs both in staff and ICT.

8. ***Costly investments: managing fees in the LGPS***

The UK's biggest fund managers are under increasing pressure to come clean on what they charge to invest their money. This session was a review of what funds should look out for when they invest and how far is it possible to reflect all investment costs.

Jonathan Hunt, Director of Corporate Finance and Investments, Tri-borough (a project between Westminster City Council, Hammersmith and Fulham London Borough Council and the Kensington and Chelsea London Borough Council to combine service provision) began his presentation by explaining the costs likely to be hidden in any external investment management arrangement, such as transaction costs, taxes, trading costs and third party brokerage fees. Identifying them depends on the investment structure, for instance pool funds that straddle countries can be very complex to analyse. Manager fees fall broadly into three categories, fixed amount (which could be linked to an inflation index), performance related and *ad valorem* (Latin for "according to value"). As an investor Funds need to assess what is a fair rate, what is the best way to compare managers' fee arrangements and whether cheaper is better.

Jonathan continued by explaining that there are various pros and cons with any of the fee arrangements which range from flat fees where the Fund benefits from good performance but managers are not penalised for underperformance, through performance related where performance needs to be time bound and what happens if performance is negative, to *ad valorem* that needs the thresholds to be tightly defined. He concluded by putting forward the arguments from research into LGPS that Funds compare well in fee negotiations, although as stated in the recent Government consultation, 10% of the assets account for 40% of the fees. Hence, there is clearly a roll for collective engagement and greater collaboration between Funds.

Nick Horton, Dalton Strategic Partnership, began his presentation with a table showing that with a 10 year investment, with a 5% annual return, a 1% increase in the annual management fee would decrease the return by 25% over the 10 years. He introduced the idea that it would be better for funds to calculate the Total Expense Ratio (TER) as this provided a truer indication and comparator of costs within and between funds. These costs consist primarily of management fees and additional expenses such as trading fees, legal fees, auditor fees and other operational expenses. The total cost of the fund is divided by the fund's total assets to arrive at a percentage amount, which represents the TER:

$$\text{Total Expense Ratio} = \frac{\text{Total Fund Costs}}{\text{Total Fund Assets}}$$

In response to questions both Jonathan and Nick indicated that more can be done to capture and analyse costs; however, they recognised there is an increased cost to do so and this information is not always identifiable. Both emphasised the need for a full statement of fees that would include the hidden and explicit fees, for greater transparency. The issue then would become one of controlling not only the fee structure but also the turnover in transactions in order to keep the costs down; which leads you to more passive fund management arrangements. As an aside it was mentioned that the new transactions levy would inevitably increase costs.

It was later announced by Bob Summers that Cipfa is to publish good practice guides on fee disclosures in the near future.

9. ***Concurrent Sessions***

A number of concurrent sessions were delivered:

a) Engaging with change: employers in the LGPS

Chaired by Helen Forrest, Head of Policy and Advocacy, NAPF, this session looked at the time following the valuations being complete, the new scheme being implemented and increased governance risk management requirements coming into force, how are funds currently engaging with their employers about all this change? And from both sides of the fence, how should this engagement change in the future?

Nigel Thomas, Specialist in Public Sector, Mercer, began his presentation from the historic employer/advisor perspective of engaging with change, i.e. the fund setting the funding strategy, gathering of membership data, setting the investment strategy and agreeing the assessment of funding position with the actuary. He then moved on to the topic of assessment of employer covenant profiling, i.e. each employer's capability of meeting its ongoing pension and deficit payments. He indicated that he thought that the administrating authority owes a fiduciary duty both to the scheme employers and to scheme members. As a consequence there are some flexibilities offered in dealing with employers individually, e.g. the ability to invest each employer's assets differently in order to reduce investment risk. The remainder of his presentation dealt with the potential to notionally manage differing funding strategies for each employer based on the maturity and liability profile of each employer.

b) Distressed opportunities investing

Chaired by Phil Triggs, Strategic Finance Manager, Surrey County Council, this session looked at the sectors of the global economy that in the aftermath of the financial crisis are emerging from operational distress but remain capital starved. So where are the best private equity opportunities in this global distressed landscape and how can pension funds optimise both direct investments and multi-manager structures to capture good risk-adjusted returns from these opportunities? The session also looked at how investors can keep fees under control to create good net-of-fee returns while still being able to access sector specialists to diversify their investment risk and see the best global opportunities.

Marianna Fassinotti, Portfolio Manager, Siguler Guff & Company, LP (a BNY Mellon specialist investment manager), began her presentation by explaining what is meant by distressed investing. This means taking into account either cyclical or episodic moments in the market that for a period increases the perceived risk to investing. This is caused in the capital market when the risk to refinancing or default risk is higher or imbalances exist between demand and supply; or internally to companies when cashflow coverage of fixed costs looks poor or balance sheets look to highly geared; or strategic defaults when external factors such as proposed legislative changes or global issues impact adversely on a market or companies. Her presentation then progressed to alternative strategies and opportunities to maximise returns through distressed investing and gave a few examples that they had taken advantage of, e.g. in banking, shipping and broadcasting.

c) To maximise investment returns above all else
Chaired by Will Pomroy, Policy Lead: Corporate Governance, NAPF, this session looked at how pension scheme investments - such as those in tobacco companies and local infrastructure - often elicit passionate and polarised views. Also, in light of the recent QC advice on fiduciary duty, how should schemes best manage their investments while fulfilling other responsibilities and navigating the associated reputational, ethical and moral factors?

Liz Woodyard, Investments Manager, Avon Pension Fund, began her presentation by explaining Avon Pension Fund’s view of what is meant by responsible investing. By understanding its fiduciary duty but also setting out a set of core beliefs on the non-financial risks which can have a significant financial or detrimental impact upon investment returns and to what extent these risks will be managed. The ensuing investment strategy then applies across all asset classes and determines the Funds voting and engagement strategy and approach to collaboration. However, Avon recognises the limitations in applying these beliefs, such as in pooled funds and passive investment strategies, and the need to engage with investment managers and that this is a long term approach. Greater collaboration in common investment vehicles will increase the collaborative role that Members and Officers need to have in order to reduce the potential to invest in the ‘Wonga’s of this world and to avoid investing in companies that make cluster bombs etc.

Niall Mills, Head of Infrastructure Asset Management, First State Investments, gave a presentation on First State’s approach to responsible investment. This included embedding an Environmental, Social and Governance (ESG) approach throughout the investment cycle. When taking positions in companies this would include setting up board-level safety committees, ensuring that risk registers included safety, environment and carbon management risks, and ensuring that various ISO energy management and health and safety management accreditation is retained.

10. ***The Future of the LGPS***
This was the long awaited speech by Brandon Lewis on the future of the LGPS which began with him thanking everyone for implementing the new CARE scheme

but also indicating that there was more work to be done, particularly on governance, the interaction between local and national boards and the cost cap! He moved on to the area of the response to the call for evidence where he indicated that he had listened and that a new consultation for reform had been published. No fund mergers at this time as there was a recognition that the democratic accountability argument had won out. Instead we should pursue common investment vehicles (CIV) to reduce fund manager fees with targeted annual savings of £240 million and a move to more passive management of listed assets with annual saving up to £230 million on fund manager fees, with an additional £190 million annual saving on transaction costs. There should be a move to more coherent and transparent gathering of costs so the LPGS can demonstrate value for money for taxpayers which will be a task for the Shadow Board. Fund deficits nationally are at 20% so innovative measures for managing deficits are required which will be another task for the Shadow Board. He finished by reminding everyone that the consultation finishes on the 17th July.

Mr Lewis defended his position well through the question and answer session. Most of his responses to issues such as active management, differing funds risk appetites, the shortcomings with CIVs, volatility and valuation issues, as well as the call for evidence process and the new consultation were dealt with by his highlighting that these issues were to be expected and should be addressed with evidence in the responses to the new consultation.

It wasn't possible for Mr Lewis to inform anyone now of the timetable for change following the consultation as this will obviously depend on the kind of legislation that needs to be enacted.

Mr Lewis' response to Councillor Rigby's question regarding the withdrawal of councillors from the LGPS stuck to the line that councillors are not employees and so are not entitled to be members of the LGPS. The exchange as reported in the Local Government Chronicle is as follows:

"Ken Rigby (Lib Dem), of Nottinghamshire CC, said: "you have dumped us councillors out of the scheme, and insultingly call us 'volunteers'. My pension will be, after 10 years, £20 per week. In the past 10 years, MPs have enhanced their scheme dramatically. You have put your snout in the trough at the expense of councillors"

Speaking over cheers from the conference floor, Mr Lewis said the prime minister had cut ministerial salaries by 5% and that the ministerial and MP pension schemes "were being reformed".
Mr Lewis added: "Just 16% of the LGPS is councillors, and only 3% of councillors are in the LGPS. I was a councillor; I appreciate what is involved. I know it can be one hour a week after work, or much more."

Mr Lewis suggested that they were still open to councils making the case for executive councillors and leaders maintaining scheme membership. However, a few days later the DCLG subsequently announced that the legislation on councillors' pensions has passed through parliament and councillors' pensions have been abolished, subject to the transitional provisions.

A representative from the North Yorkshire Pension Fund then indicated that active management outperformed passive management and that going passive would have resulted in a loss in investment income. Mr Lewis's response, suggesting that the evidence of scheme deficits would counter this argument, caused the greatest response from the conference floor as unfortunately Mr Lewis demonstrated his misunderstanding of how scheme liabilities and fund deficits are calculated.

11. ***Concurrent Sessions***

A number of concurrent sessions were delivered.

a) Governing LPGS 2014

Chaired by Bob Summers, CIPFA, this session looked at how funds should prepare for the new scheme governance arrangements and gave a chance to hear the latest detail on the regulations and how the Regulator plans to police the new arrangements.

Jeff Houston, Head of Pensions, Local Government Association, began his presentation with a recap of the Public Service Pensions Act 2013 which will see four distinct roles to be performed within each scheme; the Responsible Authority, The Scheme Manager, the Pensions Board and the Scheme Advisory Board. For the LGPS the Responsible Authority is the Secretary of State for Communities and Local Government.

The Act defines a Scheme manager as the organisation named as the administrating authority (e.g. Nottinghamshire County Council). The authority then discharges the function of scheme manager using Local Government Act 1972 section 101/102 to a person, committee or joint committee. The committee is not the scheme manager, merely the vehicle for discharging the function. Pension boards are bodies created by the Act. For the LGPS these will exist at the individual 'fund' level and will therefore be replicated across the LGPS.

Regulations exist currently only in draft form and are not expected until the autumn; however, there is a need to remember that the length of a Parliamentary autumn is longer, with an implementation date of 1 April 2015. As well as the nature of local governance the regulations will also cover the statutory scheme advisory board, timing, funding and reporting requirements.

Bob Scruton, Head of Public Service Pension Scheme, The Pensions Regulator, reminded everyone of The Regulator's role; explicitly regulatory oversight of governance and administration – not funding. When the Regulator calls they will be checking that the legal requirements are being fulfilled by the Scheme manager, such as record keeping, internal controls, and the publication of annual member statements, the internal dispute resolution procedures and conflict of interests of pension board members. They will also be reviewing Pension Board members' level of knowledge and understanding and the scheme whistle-blowing policy and procedures. Their role will firstly be to educate, enable and then enforcement which will be determined by the extent of breaches of pensions legislation.

b) The attractions of ‘unloved’ property
Chaired by Helen Roberts, Policy Lead: Investment, NAPF, this session looked at the ‘flight to safety’ in recent years which has led to substantial investment in UK high quality prime real estate assets, principally in London, consequently, investors have, up to now, shunned lower quality secondary properties but the tide is now turning with potential opportunities opening up for local authority pension schemes to invest.

Nick Vikers, Head of Financial Services, Kent County Council, began his presentation with some facts regarding Kent CC Pension Fund; £4.1 billion fund, 83% funded with 10% allocated to property through DTZ Investment and Asset Management, and moved on to the rationale for holding property which is akin to Nottinghamshire’s view. However, he indicated that there appeared to be a lack of options for increasing their allocation, until secondary property opportunities. This strategy focuses on smaller lot sizes, with higher net initial yield as assets are sourced from ‘distressed’ sellers, with some potential capital uplift.

Phil Clark, Head of Property Investment, Kames Capital, began his presentation with the history of the property cycle, which demonstrated that, although property yields and rental growth have followed the global financial crisis cycle, income returns have remained roughly constant over the same period thereby demonstrating that property offers a stable and reliable income stream. He continued with facts about the history of property investments in the UK. Namely, how Irish money disappeared after the 2008 recession to be replaced now with investments from Asia (mostly China and sovereign wealth funds), and from Japan. It still appears that for international property investors, investing in the UK equals investing in London (representing 76% of all inward investment).

His presentation concluded with his view that, although the gap between prime and secondary property yields was narrowing, the lack of availability of debt finance means there are still opportunities in the secondary market with growth forecasts for 2015 of between 7.8% and 10.7%.

c) Easy wins to increase efficiency in your investment portfolio
Helen Forrest, Head of Policy and Advocacy, NAPF, chaired a panel session exploring various implementation techniques that could help funds be more nimble and cost-effective as they experience changes to their investment strategy, bearing in mind volatile markets and changing regulations affecting LGPS.

Presentations from Tolu Osekita, Northamptonshire and Cambridgeshire Pension Fund and from Klaus Paeslar, Head of Currency and Overlay Strategy for the EMEA Region, Russell Investments, indicated that pension funds should and do spend most of their time determining their strategic asset allocation and that transaction costs and opportunity cost can have a significant impact on a portfolio’s performance. The remainder of the presentation regarded the potential use of a Russell Investments tool/technique to help minimise implementation costs of a fund's asset strategy which would enable asset allocation to switch more quickly or to shift from active to passive.

12. ***Governance: is it time to go our separate ways?***

One of the emerging themes from the call for evidence was the need to review the governance structure of the LGPS. This session looked at the question of whether it is finally time for employers and scheme managers to go their separate ways and how will governance get us through any restructuring of the LGPS.

Joanne Segars, Chair of the Shadow Board, set the basic question as to whether Pension Boards and Scheme Managers should be the same or not? Her presentational argument was that Pension Boards need to oversee the work of the Scheme Manager and so should be separate, otherwise it's like 'marking your own homework'. This also meant Pension Boards will be free to set their own priorities, targets and objectives outside of the Scheme Manager's influence.

Gary Delderfield, partner at Eversheds LLP, gave the legal view indicating that separation of the roles would provide greater transparency and consistency (i.e. not subject to local authority elections). However, there is a need to recognise that the LGPS is different in that it is not a trust-based scheme. It is bound by LGPS Regulations not by choice. That separation of roles can be achieved by delegation to pension committees and boards rather than any messy divorce. Overall the scheme manager has a fiduciary duty to employers and members (and public law) *"the administrating authority's power of investment must be exercised for investment purposes, and not for any wider purposes".*

Nicola Mark, Head of the Norfolk Pension Fund, ran through the history surrounding governance issues particularly those that followed the Hutton Review in 2011. She indicated that we should remember that the Co-op has a democratically elected board to manage its business and see how successful that organisation has been. Nicola's presentation then continued with her experience of complications arising in pension funds when parts of the governance of a pension fund are managed by different parts of the organisation. This can only lead to confusion over responsibility and accountability over scheme management. This mirrored the argument for not splitting any role between scheme manager and pension boards.

In responses to questions Gary argued we should keep it as it is, though it is recognised that the Pensions Regulator should issue common guidance that would be of practical help to manage these two roles.

13. ***The 2013 valuation: a critical year for the LGPS?***

The latest round of valuations was expected to be disappointing – austerity has impacted on cash flow and persistent low bond yields have repressed returns. Now the valuation is complete and the dust has settled, this session looked at what will be the impact on LGPS funds investment strategies.

Jo Holden, partner at Mercer, provided an update on the valuation results so far. The median funding level was 78%, the upper quartile was at 83%. However, as anticipated the review of the data would suggest that if the assumptions on discount rates (modelled on gilt yields) were set nationally for all funds (based on their model of gilt yields) then the results on funding levels would vastly different. This would show some upper-quartile funded funds dropping significantly below the median level. This represents the different risk in the valuations.

Jo continued her presentation with the theory that having taken the benefit of the increase in equities over the last year pension funds should lock these gains in by re-balancing the portfolio with the take-on of more index-linked gilts. She completed her presentation with an example of where Mercer had supported Cheshire Pension Fund in formulating this strategy (a fund with a funding level of 82%).

Unfortunately, in her post presentation response to a question regarding locking in the gains into better performing equities rather than bonds, Jo indicated that this alternative strategy would be just as good, as over time equities have outperformed bonds.

14. ***Changes are going to come***

The economy may be recovering slowly but local authority budgets continue to be stretched, and funds are continuing to deal with the cost implications of the new scheme and impact of wider reforms to the LGPS. This session looked at what impact all this change will have on funds and their members in the short and medium term.

Chris Megainey, Deputy Director for Workforce, Pay and Pensions, DCLG, gave the DCLG view of what they want to do over the coming years. This included the finishing touches to the pension scheme 2014 regulations, the governance regulations for 2015, cost control regulations, fair deal (for people contracted out of local government employment), councillor pensions, potential changes to the investment regulations and completion of the structural reform consultation and any ensuing regulations. They also wanted to look at pension fund data availability and transparency, especially over investment manager’s costs etc., and would want to look at other issues including workforce profiles and the number of employers in the scheme.

Brian Strutton, National Secretary for Public Services, Joint Secretary of the National Joint Council for Local Government, GMB, explained the differing national valuation modelling undertaken by HMT and GAD regarding the long-term sustainability target of 19.5% (split 13.0% employers/ 6.5% employees) set by GAD as opposed to the HMT model of 20.5%. Full calculations will not be available until September 2015; however, initial analysis from the 2013 valuations indicates the future service rate is increasing. There is obviously some need to understand why it is increasing to see if this is structural or temporary. Corrective action may result if the scheme basis moves at all and must result if either basis moves by +/- 2%.

Brian concluded his presentation with his initial view of the valuation data. It appears that around a third of actual employer contributions are deficit repayments (recovery); that too many employer contributions are too high a level to be sustainable; and that the debt recovery periods are not reducing (with the average just below 20 years). However, there is still a way to go to understand what is happening with costs and what we should do about struggling funds.

Hugh Grover, Director (policy) Fair Funding, Performance and Procurement, London Councils, gave an update on the progress the London Councils are making on setting up a Collective or Common Investment Vehicle (CIV). Hugh explained the rationale for setting up such a structure and the complications there has been, including the investment regulations, in setting this up. The structure of such a vehicle looked very complicated with the need for one fund manager to be employed to run the 'Authorised Contracted Scheme' (ACS), managing a number of sub-funds based on asset class (but could include numerous managers within a class) and the governance structure that sits around this to ensure all councils participate, manage the ACS and continue to determine their own differing asset investment strategy, allowing them to invest in some or all of the sub-funds to a varying degree. So far 21 of the 33 councils have signed up to the establishment of the CIV and the next step is to establish the company, the various committees and to procure a fund manager/partner for the ACS. Hugh was hopeful that this would be operational in 12 months.

Hugh's concern was that the outcome from the structural reform will influence the work they have been undertaking and was hopeful that amendments to the pension investment regulations may be out in the autumn which may be helpful in overcoming some existing issues. Hugh also indicated that the operator of the ACS would not be able to provide the financial advice so felt a separate investment sub-committee would be required with its own independent financial advice.

It became apparent that the additional governance arrangements and the use of managers within the structure of the ACS would not necessarily provide the savings on costs, nor could it guarantee improved investment performance as originally envisaged.

15. ***The changing face of the LGPS***

There is a wide range of employers in the LGPS and the numbers are increasing. This session looked at how funds manage the changing nature of their employer members, the issues in the actuarial valuation and what are the future governance implications.

Peter Morris, Director, Greater Manchester Pension Fund, concentrated on the history of the GMPF which showed the changes in the fund from 1974, showing the changing make-up of percentage of employees that are from local authorities (shown as Laish in table below) and the large increase in the number of employers, as well as details of the fund;

	1974	1989	2001	2013
Employees	61,000	75,000	94,000	88,000
Deferred Members	198	14,600	34,700	96,000
Pensioners	15,600	42,200	67,000	92,000
% of employees Laish	95		84	73
Employers	37	78	184	342
Assets	£77m or £107m	£2bn or £1.9bn	£6.3bn	£12.6bn
Surplus / deficit	10% of pay	£225m 6.3%	£0.3bn 9.7%	(£1.2bn) 16.4%

As a consequence they have needed to review employer viability and employer asset allocations in planning to reduce investment risk.

Joseph Carr, Policy Leader (Finance), National Housing Federation, began his presentation with an overview of the differing types of pensions in the social housing sector, including LGPS, own defined benefit trusts, defined contribution schemes and the Social Housing Pension Scheme, managed by The Pension Trust. It is already a complicated picture for determining employer contributions and liabilities, which is added to by the differing treatments by LGPS for the NHS members, based on a misunderstanding of the financial challenges facing housing associations' treatment as admitted bodies or unincorporated charities. Joseph's argument was that all LGPS should treat housing associations the same in the valuations or even better if, like the Probation Service, they were all transferred to be administered by one authority.

Steve Simpkins, KPMG, began with the differing determination of discount rates by the main actuaries for the 2013 valuation. He showed a graph showing Hymans Robertson with the lowest rate, and hence potentially higher past service liabilities, to that of Aon Hewitt or Barnet Waddingham. He continued with the theme that there were wide variations between funds for measuring liabilities and recovery periods for admitted bodies to that of schedule bodies. He singled out academies which he asserted should be pooled separately to the original scheduled body. He argued that central guidance should be provided on the treatment of similar employers and would go even further to suggest central pools across all 89 LGPS for employer types akin to the desires portrayed in Joseph Carr's presentation for the treatment of housing associations.

As expected in response to Steve's presentation, representatives from both Aon and Hyman's criticised Steve's simple assertion, arguing instead that it was about covenants and financial backing to the admitted body that resulted in differing rates. It was also pointed out that the LGPS allows all employers a chance to contribute to the debate on asset allocation.

16. **Passive vs active? Internal vs external?**

Now reform is officially on the table this session looked at what change could look like, and whether it is just about deciding the best investment approach.

This was an open debate, chaired by Joanne Segars, and led by a presentation given by John Simmonds, CEM Benchmarking. His presentation began with an explanation of the large number of global defined-benefit pension funds that his company's benchmark data was drawn from; which included 42 UK funds (including 26 LGPS funds). Focusing on LGPS, this indicated that private equity alone represented approximately 4% of the combined LGPS's assets but 25% of its costs. 41% of combined LGPS's private markets assets were in fund-of-funds compared with 16% amongst peers. And performance over the last 5 years would indicate that paying more did not necessarily get you more. Based on a 22 year annual average, this showed the net value added by active management providing only 0.15% returns, net of the strategy return from selecting the asset allocation, above market indices. His message was that the data indicated that internal passive management was by far the most efficient route.

Additional contributions were then given by Mark Chaloner, West Midlands Pension Fund, and Steven Daniels, Tesco, both indicated that from their experience they supported the results from John's analysis. Steven reiterated the point that it is the asset allocation that was most important in investment performance and until he internalised the Tesco fund's investment management it was often the case that one fund manager's decision to sell a stock was normally a trigger for another to buy the same, only leading to additional costs. Tesco strategy has been to internalise the management of the funds and rationalise the fund managers, which he considers has improved investment performance.

Both Tesco and WMPF have reasonable internal passive management of investments. Being a larger fund, Tesco has included internalising not only equities, but also real estate and bonds.

The debate on whether size matters was more mixed, with Mark suggesting that from his experience smaller funds have been as successful in internalising the management of investments, whilst others felt that there was a critical mass. John indicated that the evidence indicates that large funds do outperform smaller funds on performance that is driven by cost differences but was unable to define what was meant by small.

Steven felt that the danger to outsourcing into CIVs was that individual funds would be a small part of very large funds and the danger that fund managers would just lift and shift a strategy that doesn't necessarily fit with local accountability or needs. The main danger of the current debate was that we would find the price of everything but the value of nothing [Oscar Wilde – definition of a cynic].

Statutory and Policy Implications

17. This report has been compiled after consideration of implications in respect of finance, equal opportunities, 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.

RECOMMENDATIONS

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