Meeting: **Local Pension Committee**

Date/Time: **Friday, 22 January 2016 at 9.30 am**

Location: **Guthlaxton Committee Room, County Hall, Glenfield.**

Contact: **Mr. M. Hand (Tel. 0116 305 6038)**

Email: **matthew.hand@leics.gov.uk**

AGENDA

Item		Report By	Marked
1.	Minutes of the meeting held on 14 November 2015.		(Pages 3 - 10)
2.	Question Time.		
3.	Questions asked by members under Standing Order 7(3) and 7(5).		
4.	To advise of any other items which the Chairman has decided to take as urgent elsewhere on the agenda.		
5.	Declarations of interest in respect of items on the agenda.		
6.	Local Government Pension Scheme Investment Reform.	Director of Corporate Resources	(Pages 11 - 106)
7.	Report of Kames Capital - Market Review.	Kames Capital	(Pages 107 - 112)
8.	Strategic Investment Benchmark and Portfolio Structure of the Fund.	Director of Corporate Resources	(Pages 113 - 154)
9.	Any other items which the Chairman has decided to take as urgent.		

TO:

Leicestershire County Council

Mr. G. A. Hart CC (Chairman)
Mr. S. J. Hampson CC
Mr. Max Hunt CC
Mr. K. W. P. Lynch CC
Mr. P. C. Osborne CC

Leicester City Council

Cllr Deepak Bajaj and Cllr. Lynn. Moore

District Council Representatives

Cllr. Malise Graham MBE and Cllr. Thomas Barkley

University Representative

Mr. J. Shuter

Staff Representatives

Miss. J. Dean
Mr. R. Bone
Mr. N. Booth

Agenda Item 1

Leicestershire County Council

Minutes of a meeting of the Local Pension Committee held at County Hall, Glenfield on Friday, 13 November 2015.

PRESENT:

Leicestershire County Council

Mr. G. A. Hart CC (Chairman)
Mr. S. J. Hampson CC
Mr. Max Hunt CC
Mr. K. W. P. Lynch CC
Mr. P. C. Osborne CC

Leicester City Council

Cllr Deepak Bajaj and Cllr L. Moore

District Council Representative

Cllr. Malise Graham MBE

Staff Representatives

Mr. R. Bone
Mr. N. Booth

Independent Advisers and Managers

Mr. S. Jamieson

358. Minutes of the previous meeting.

The minutes of the meeting held on 4 September 2015 were taken as read, confirmed and signed.

359. Question Time.

The Chief Executive reported that no questions had been received under Standing Order 35.

360. Questions asked by members.

The Chief Executive reported that no questions had been received under Standing Order 7(3) and 7(5).

361. Urgent items.

There were no urgent items for consideration.

362. Declarations of interest.

The Chairman invited members who wished to do so to declare any interest in respect of items on the agenda for the meeting. No declarations were made.

363. Summary Valuation of Pension Fund Investments and Investment Performance of Individual Managers.

The Committee considered a report of the Director of Corporate Resources, the purpose of which was to present a summary valuation of the Fund’s investments at 30th September 2015 together with figures showing the performance of individual managers. A copy of the report is filed with these minutes, marked ‘6’.

The Committee noted that whilst investment results had been variable during the latest quarter, the Fund’s investment strategy was based on long term expectations of performance and that there were always likely to be periods of volatility and/or negative performance.

RESOLVED:

That the report be noted.

364. Pension Fund Annual Report and Accounts 2014/15.

The Committee considered a report of the Director of Corporate Resources, the purpose of which was to present the Annual Report and Accounts of the Pension Fund 2014/15 for approval. A copy of the report is filed with these minutes, marked ‘7’.

RESOLVED:

That the Annual Reports and Accounts for 2014/15 be approved.

365. Annual Audit Report in Respect of 2014/15 Pension Fund Audit.

The Committee considered a report of the Director of Corporate Resources, the purpose of which was to present the 2014/15 Annual Audit Report of the Pension Fund, including the Annual Accounts. A copy of the report is filed with these minutes, marked ‘8’.

RESOLVED:

That the Pension Fund’s Annual Audit report for 2014/15 be noted.

366. Update on Actuarial and Investment Consultancy Services.

The Committee considered a report of the Director of Corporate Resources, the purpose of which was to provide an update on the previously agreed market testing exercise for potential providers of the Fund’s actuarial and investment consultancy service. A copy of the report is filed with these minutes, marked ‘9’.

The Director reported that the recent government initiative for Local Government Pension Scheme’s to take a more collaborative approach to investments and the tight timescales for the formation of such agreements, had resulted in officers being unable to undertake market testing as originally planned. It was noted that officers remained satisfied with the service provided by Hymans Robertson and by switching to the Croydon Framework until officers were in a position to carry out their own market testing, immediate savings for the Fund would be achieved.

RESOLVED:

a) That the previously agreed market testing for actuarial and investment consultancy services be postponed;

b) That the Fund utilises the Croydon Framework Agreement in respect of Actuarial Services with Hymans Robertson.

367. Asset Pooling Within the Local Government Pension Scheme.

The Committee considered a report of the Director of Corporate Resources, the purpose of which was to inform the Committee of the current position in respect of the potential pooling of Local Government Pension Scheme assets. A copy of the report is filed with these minutes, marked ‘10’.

The Director reported that whilst informal discussions between authorities concerning the formation of investment pools were ongoing, the Department for Communities and Local Government would ultimately be responsible for the strategy of pooling arrangements. It was expected that an announcement concerning future arrangements would be made in the Chancellor’s budget statement in March 2016, although guidance regarding the required criteria was expected by the end of November. In the meantime local authorities would continue to develop proposals for the structure of future pooling arrangements.

RESOLVED:

That the report be noted.

368. Funding Update as at 30 September 2015.

The Committee considered a report by Hymans Robertson which presented the funding projection at 30 September 2015. A copy of the report, marked ‘11’, is filed with these minutes.

The Committee noted that whilst the Fund’s investment returns had been encouraging in the last quarter, the rise in gilt yields, a factor the Fund had no control over, had had a negative impact on the Fund’s overall position.

RESOLVED:

That the update be noted.

369. Market Update.

The Committee received a presentation by Kames Capital concerning global market conditions. A copy of the presentation marked '12' is filed with these minutes.

RESOLVED:

That the update be noted.

370. Exclusion of the Public.

RESOLVED:

That under Section 100(A) of the Local Government Act 1972 the public be excluded from the meeting for the following items of business on the grounds that they involve the likely disclosure of exempt information as defined in paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Act

371. Action Agreed by the Investment Subcommittee.

The Committee received an exempt report by the Director of Corporate Resources, the purpose of which was to inform members of a report considered by the Investment Subcommittee at its meeting on 14 October 2015 concerning the performance of Delaware Investment and the subsequent discussions which had taken place between officers and representatives of Delaware Investment regarding the investment fee charged to the Fund. A copy of the report marked ‘15’ is filed with these minutes. The report was not for publication by virtue of Paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the revised fee proposal from Delaware Investments be approved.

372. Passive Investment Manager Procurement with six Other Local Government Pension Funds.

The Committee received an exempt report by the Director of Corporate Resources, the purpose of which was to inform members of a procurement exercise carried out by seven Local Government Pension Scheme (LGPS) Administering Authorities in respect of the appointment of a passive investment manager. A copy of the report marked ’16’ is filed with these minutes. The report was not for publication by virtue of Paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

373. Kames Capital Quarterly Report.

The Board considered an exempt report by Kames Capital. A copy of the exempt report marked '17' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

374. KKR - Quarterly Report

The Board considered an exempt report by KKR. A copy of the exempt report marked '18' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

375. Kempen Capital Management Quarterly Report.

The Board considered an exempt report by Kempen Capital Management. A copy of the exempt report marked '19' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

376. Kleinwort Benson Investors - Quarterly Report.

The Board considered an exempt report by Kleinwort Benson. A copy of the exempt report marked '20' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

377. Ruffer - Quarterly Report.

The Board considered an exempt report by Ruffer. A copy of the exempt report marked '21' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

378. Investec Asset Management - Quarterly Report.

The Board considered an exempt report by Investec Asset Management . A copy of the exempt report marked '22' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

379. Aviva Investors - Quarterly Report.

The Board considered an exempt report by Aviva Investors. A copy of the exempt report marked '23' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

380. Millennium Global - Quarterly Report.

The Board considered an exempt report by Millennium Global. A copy of the exempt report marked '24' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

381. IFM Investors - Quarterly Report.

The Board considered an exempt report by IFM Investors. A copy of the exempt report marked '25' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

382. Legal and General Investment Management - Quarterly Report.

The Board considered an exempt report by Legal and General Investment Management. A copy of the exempt report marked '26' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

383. Stafford Timberland - Quarterly Report.

The Board considered an exempt report by Stafford Timberland. A copy of the exempt report marked '27' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

384. Delaware Investments - Quarterly Report.

The Board considered an exempt report by Delaware Investments. A copy of the exempt report marked '28' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

385. Ashmore - Quarterly Report.

The Board considered an exempt report by Ashmore. A copy of the exempt report marked '29' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

386. Aspect Capital - Quarterly Report.

The Board considered an exempt report by Aspect Capital Investment Management. A copy of the exempt report marked '30' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

387. JP Morgan - Quarterly Report.

The Board considered an exempt report by JP Morgan. A copy of the exempt report marked '31' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

09.30 – 11.05am CHAIRMAN
13 November 2015

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Leicestershire County Council

LOCAL PENSION COMMITTEE – 22ND JANUARY 2016

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

LOCAL GOVERNMENT PENSION SCHEME INVESTMENT REFORM

Purpose of the Report

1. To inform the Committee of the latest position in respect of the on-going national discussions into the future shape of the investments of the Local Government Pension Scheme (LGPS), and to recommend a strategy in respect of becoming part of an investment pool.

Background

2. In May 2013 the then-Local Government Minister made it clear in a speech that the structure of the LGPS was being considered, with Fund mergers a possible option. This speech was followed by a 'Call for Evidence' consultation that focused on the management of deficits and investment efficiency.

3. In May 2014, and following analysis of the responses received from the Call for Evidence, a further round of consultation was launched. This consultation ruled out forced Fund mergers in the near term and focused on the possibility of asset pooling (possibly via the formation of a small number of Common Investment Vehicles) and the increased use of passive management, both of which were thought to offer potentially significant savings in investment management fees across the LGPS.

4. The Summer Budget of July 2015 contained the following announcement:

   "The government will work with the Local Government Pension Scheme administering authorities to ensure that they pool investments to significantly reduce costs, while maintaining overall investment performance. The government will invite local authorities to come forward with their own proposals to meet common criteria for delivering savings. A consultation to be published later this year will set out those detailed criteria as well as backstop legislation which will ensure that those administering authorities that do not come forward with sufficiently ambitious proposals are required to pool investments."

5. Subsequent to the Budget, it became clear that there would be no formal consultation on the matter of asset pooling. Instead, discussions between individual Funds, representatives of Funds (such as the Local Government Association and investment consultants), the Department for Communities and Local Government (DCLG) and the Treasury were considered to form the necessary consultation.

6. In late November 2015 the Department of Communities and Local Government (DCLG) issued a document entitled 'Local Government Pension Scheme:

Investment Reform Criteria and Guidance'. This document had been widely anticipated and did not contain any surprises to those Funds that had been close to the discussions that had been taking place between the interested parties. A copy of the document is attached as Appendix 1 of this report.

7. The DCLG also issued two other documents on the same date. One was a response to the consultation referred to in paragraph 3 of the Criteria and Guidance document, and this is attached as Appendix 2. The other was a consultation named 'Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 which is attached as Appendix 3.

<u>Investment Reform Criteria and Guidance</u>

8. Whilst it has been clear for many months that a reform of the manner in which LGPS Funds invest their monies was inevitable, the publication of the document 'Local Government Pension Scheme: Investment Reform Criteria and Guidance' was the first time that the criteria against which the various options would be judged have been formally laid out.

9. The document sets out the following four key criteria:

A. Asset pools that achieve the benefits of scale – minimum size £25bn;
B. Strong governance and decision making – the governance structure should provide strong governance at both a local Fund level, and also at a pool level;
C. Reduced costs and excellent value for money;
D. An improved capacity to invest in infrastructure.

10. The criteria also stated that the pools should take the form of 'up to six British Wealth Funds'. It would actually be possible for the LGPS to form more than six pools and still meet the minimum size criteria for each one, but it is not thought likely that this will be accepted as an outcome.

11. There is a possibility that an exception may be made for the eight Welsh LGPS Funds (with combined assets of c.£13bn), with the intention that they will in future become the responsibility of the Welsh Assembly – as is the case in Scotland, where the Scottish Parliament has responsibility for the Scottish LGPS – but this is ultimately likely to be a political decision. If this does happen, it is by no means certain that the government would allow six pools for England.

12. A Common Investment Vehicle (CIV) already exists for the London Boroughs and although it will require some changes to meet the government's criteria (investing through it is currently optional, for example) there is little doubt that a London CIV will be one of the six pools. As a result, there are likely to be only five other pools allowed, and if Wales becomes one of these the number may be reduced to four. It is, however, difficult to envisage circumstances whereby the government will accept a sub-scale Welsh pool and not also allow five English (excluding London Boroughs) pools, given that there is a possibility that restricting this to four will bring certain diseconomies of scale and more difficult governance.

13. Under the guidance of Hymans Robertson, Leicestershire has been one of over 20 LGPS Funds that have been collaborating since August 2015 in an attempt to

influence government thinking into pooling, via direct meetings and through the production of a report that looked into various possible pooled investment structures. This report commenced as a number of ‘workstreams’ based on asset classes (equities, bonds, property etc.), styles of investment management (internal, passive etc.), or other factors (regional pooling, risk factors etc.), before being refined down to a proposal that all parties were in agreement with. The final version of the report, which is expected to have been published before this meeting but had not been at the time of writing this report, was much slimmed-down from the more detailed workstream reports, but does provide sufficient detail to explain why the final proposal was the preferred option.

14. Pools based on asset classes were ultimately not considered the optimal structure (with the exception of an infrastructure platform) for a number of different reasons – for example, active equities would have produced a pool that was simply too big to manage effectively, whilst others would have been too small. Although there were potential additional fee savings that could have been achieved by asset class pools these were fairly negligible, and governance of them would have been much more difficult than other options. The potential of having 90 Funds all represented on a management committee is unlikely to have led to efficient decision-making.

15. The preferred options of the Funds that were responsible for the report was as follows:

- 6 multi-asset, multi-fund pools;
- An infrastructure platform (which will include a number of different methods of investment) that will be available to the whole of the LGPS, and through which the LGPS will be expected to invest all future infrastructure monies.

16. Given the government’s inclusion of infrastructure as one of the four criteria, and given that having six multi-fund pools all trying to invest relatively modest amounts into the asset class is sub-optimal, a national infrastructure platform gives a potentially improved ability to invest successfully within the asset class. As an example, Co-investment with other investors or even direct investment in specific assets becomes more possible if there is a national infrastructure platform than if there are six LGPS multi-asset pools all looking for similar types of investment (and potentially competing with each other).

17. It should be made clear that none of the Funds involved has any wish to invest in infrastructure assets that do not offer returns, on a risk-adjusted basis, that they consider acceptable. A national infrastructure platform is not intended to be a method whereby the LGPS can fund the UK government’s required infrastructure spending, and unless these individual assets are attractive they will not be purchased. The onus is on the UK government to provide investments that have terms that are sufficiently attractive both in absolute terms and also relative to other available infrastructure investments. If this does not happen there is unlikely to be any LGPS investment in UK government infrastructure projects.

18. It was always considered likely that the DCLG considered ‘regional’ pools to be the default option if there was no common agreement across the LGPS, assuming that no other structure had clear advantages over it. During the period in which discussions have been taking place a number of ‘alliances’ have been formed within the LGPS and whilst many of these could be broadly described as regional, there

are others that are spread more widely on a geographical basis. As a result, the term 'regional' has been superseded by the term 'multi-fund', or 'like-minded'.

Potential LGPS Pools and Proposals for the Leicestershire County Council Fund

19. The government is asking each Fund to put forward proposals for pooling scheme assets by 19th February which should include 'a commitment to pooling and a description of their progress towards formalising their arrangements with other authorities'. These proposals will be assessed against the four criteria set out in paragraph 9 above. With this in mind, and given the speed at which potential pools were moving forward it was necessary for Officers to become involved in the on-going discussions.

20. The two potential pools that appear to fit Leicestershire's broad investment beliefs and requirements best are one based on a grouping of Midlands Funds (with a working title 'LGPS Central') and one calling itself ACCESS (Collaboration of Central, Eastern and Southern Shires). There is no reason to suggest that Leicestershire could not work effectively with either of these groups, or indeed with a number of the other groups, but it has been necessary to focus on the one that appears to have the most positive points and to engage fully with that one.

21. It is officer's belief that LGPS Central has a slight advantage over ACCESS. There remains the possibility of Funds being able to 'switch' pools between the initial February submission and the 'refined' submissions required in July, and it is probably the case that some Funds will do exactly this, but this should be considered a last resort. Unless there are very clear reasons why LGPS Central no longer looks attractive to Leicestershire, the intention is to remain actively involved in shaping the structure and governance of that pool as much as possible.

22. Within any collaborative arrangement it is important that the individual Funds all share common beliefs in many areas, including governance structures (and in particular one Fund-one vote), the long-term nature of investment decisions, their stance towards responsible investment, willingness to collaborate with other pools, the need to retain sufficient internal expertise, the necessity for internal investment arrangements to be judged on the same standards as external arrangements, and the need to be open and transparent with each other. On the basis of the three Officer meetings that have already taken place with other authorities committed to the LGPS Central pool, there appears to be a very solid agreement on these broad principles and many other factors.

23. There are currently eight LGPS Funds (including Leicestershire) that are part of LGPS Central, and six of these are the Funds that Leicestershire collaborated with in the joint appointment of an external passive investment manager. This appointment was very successful and proved the willingness of these Funds to work together towards a common goal. Whilst it is clear that the joint appointment of a manager is a much more straightforward project than the formation of an investment pool with a single governance process, there is at least some evidence that the Funds can collaborate without any friction.

24. The eight Funds have combined assets of £35bn, which is well above the government's stated minimum pool size. With eight Funds, governance can be

effective without a single Fund having too much influence – having to get at least four other Funds 'on board' for any contentious issue will not be easy. There is also scope to accept another one or two Funds without causing undue governance issues, and the extra value of assets may well be beneficial in helping to reduce costs further (although the LGPS Central does not actually need to attract any other Funds to meet the required criteria). At a recent Officer meeting, two other Funds that have not yet decided their preferred pool were present.

25. A key difference between the LGPS Central pool and some of the others is that there will be a mix of internally and externally managed assets – three of the Funds currently manage a meaningful proportion of their assets 'in house' and the staff managing these assets will ultimately become employees of the pool. There will be no compulsion on the part of all Funds within the pool to have any of their assets managed internally for a number of years, and the continuation (or expansion) of internal management as an option will ultimately be judged on the same basis as external management.

26. Some of the other pools will be entirely externally managed, and it will be difficult for them to then build internal capability if it is proven to be successful within other pools; given that internal investment management is much cheaper than external, it seems sensible to be in a pool that has the capability to offer it. If it is not successful and cost-effective, it can be phased out and only those that have chosen to use it will have suffered in the interim period.

27. Of the Funds involved with the LGPS Central pool, the West Midlands Pension Fund is by far the largest at over £11bn. It is natural to have concerns over a potential desire on their part to exert undue influence over the operation of the pool (over and above the principle of one Fund-one vote), but there have been no signs so far that this is the case. In many ways, their size is an advantage to the pool, as it means that the government's minimum required size can be reached easily without having to collaborate with another three or four funds which might make governance more difficult. In reality, there is a mutuality of need between the West Midlands Pension Fund and the other seven Funds involved, and this is an important factor.

28. There currently appear to be eight potential LGPS pools, so clearly not all will ultimately be accepted. These pools are:

- LGPS Central;
- Northern Powerhouse (West Yorkshire, Greater Manchester, Merseyside plus others);
- ACCESS (Norfolk, Northants, Cambridgeshire, Essex and others);
- London;
- Brunel (South West Counties plus Oxfordshire and the Environment Agency);
- Borders to Coast (Surrey, Cumbria, East Riding, Lincolnshire);
- Wales;
- London Pensions Fund Authority/Lancashire.

29. There are a number of Funds that have not yet committed to any of the pools, but at present three of the pools do not get near to meeting the minimum size criteria – Borders to Coast, LPFA/Lancashire and Wales. LGPS Central appears to be in a very strong position to be one of the six pools.

30. As an individual Fund it is very difficult to be actively involved with more than one pool and to still be taken seriously. In order to be able to exert full influence on the evolution of a pool, a clear commitment is preferable. Funds that initially fail to commit might find themselves in a weak position to have influence on the pool that they ultimately join, or may not even be accepted by the pool that they wish to join. Ultimately, the pools will wish to have strong and effective governance, and having too many Funds within a pool will make governance more difficult, so pools may later choose to restrict their size.

31. In addition to the above, there are two main reasons that LGPS Central appears to have advantages for Leicestershire, relative to any of the other pools. The first is the geographical proximity and the fact that Leicestershire has successfully worked with most of the other Funds very recently. The second is the inclusion of internal management within the pool from the start. It is not considered likely that Leicestershire will utilise this internal management option for a number of years, but if it does prove itself relative to external management options, it will lead to much bigger long-term savings than will be achievable via a pool that is predominately (or exclusively) externally managed. LGPS Central also appears to have a very solid commitment from enough other Funds that its probability of being accepted as one of the six 'British Wealth Funds' is high.

32. Whilst it is believed that the Leicestershire Fund is very well suited to LGPS Central, a 'breakdown' within that pool can never be entirely discounted. As a result, it is intended to remain involved, at the fringes, with ACCESS as a 'Plan B'.

New Investment Regulations

33. In November 2015 a consultation entitled 'Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulation 2009' was issued. Responses to the consultation (which is attached as appendix 3) are required by 19th February 2015.

34. The LGPS is not a trust-based scheme, and as such operates under Regulations set up using Statutory Instruments. The current Investment Regulations are relatively short and include certain restrictions about what percentage of assets can be invested in certain types of assets. The existing Regulations do not cause the Leicestershire Fund to alter its preferred investment position, although some other Funds are closer to the current limits.

35. The move towards the pooling of assets within the LGPS gives the prospect of the use of different investment structures, and the risk that the current Investment Regulations will interfere with pools being set up in an optimal manner. As a result, it is proposed within the consultation that the Regulations should be amended to a model that is similar to the 'prudent person' principle that applies in trust based pension schemes. In broad terms this puts the onus on individual funds to determine a suitable balance of investments to meet its liabilities and to clearly articulate this within an investment strategy.

36. Whilst there will be certain changes required to the policy documents of the Fund that will be required if the proposed new Regulations come into force, these will not impact onto the actual investment operations of the Fund. The purpose of the

intention for the LGPS to utilise the 'prudent person' principle is to allow greater freedom for individual Funds to be able to implement their own investment requirements, and as such the changes are to be welcomed.

37. There is a second part of the consultation into potential new Investment Regulations that is arguably more contentious – the power of the Secretary of State to intervene in the *investment function* of a Fund. In broad terms, intervention will only be considered if a Fund is not complying with guidance or best practice and has no clear plans to rectify this situation. The main purpose of the Regulations is to act as 'backstop' legislation to require 'those authorities who do not bring forward sufficiently ambitious plans to pool their investments'; in other words, to force any reticent Funds into an investment pool. Given government policy in the area of investment pooling and the possibility that some Funds may refuse to go along with this policy, backstop legislation is inevitable and should not be considered intrusive in the operation of a Fund's investment strategy.

38. The power to intervene does exist for reasons other than an unwillingness to take part in asset pooling, but it is clear that it will only be used in extreme circumstances. As long as Funds that are felt to be not achieving reasonable standards are given the opportunity to improve their performance, intervention is reasonable. Leicestershire's standards would need to drop very substantially before there became any risk of intervention.

<u>Summary</u>

39. There are a number of options available to the Leicestershire County Council Pension Fund in respect of future pooling of assets within the LGPS. Of the available options, for the reasons stated above, LGPS Central (a collection of eight Midlands-based Funds, if Leicestershire is included) has clear advantages over the others. There is a strong commitment from these Funds to progress to become one of the six 'British Wealth Funds' and all of the criteria will be met by the pool (including, crucially, the minimum asset value required).

40. The current consultation into the LGPS Investment Regulations should be viewed positively, as it improves future investment options for both individual Funds and future investment pools. The power of the Secretary of State to intervene in certain (limited) circumstances is an inevitability of greater investment freedom and a necessity in respect of the ability to deal with any Funds that refuse to join an accepted investment pool (i.e. one of the six 'British Wealth Funds').

41. Both the response to government on pooling proposals and the consultation into the LGPS Investment Regulations are required by 19th February 2016 and this is before the next meeting of the Local Pension Committee. Draft responses have not yet been produced as there are currently a number of on-going conversations with other Funds that are expected to see views shared before formal responses are prepared – in the case of asset pooling, there is likely to be a response from LGPS Central, as well as a response by Leicestershire as a stand-alone Fund, and it is important that these responses are not contradictory.

42. Although the Fund's response to either of these issues is not expected to be particularly lengthy or technical. For the reasons stated it has not been possible to prepare drafts in advance of this meeting. It is, therefore, proposed that, following

consultation with the Chairman of this Committee, the Director of Finance be authorised to prepare and submit the responses and that copies be circulated to all members of this r Committee for information.

Recommendations

43. It is recommended that

a) A firm commitment is given by the Committee on behalf of the Fund to continue to work with the LGPS Central pool to put forward a proposal to become one of the six 'British Wealth Funds;

b) That the Director of Finance, following consultation with the Chairman of this Committee, be authorised to:

   i. Respond to the government on its initial proposals for pooling scheme assets, detailing the Funds commitment to pooling and its progress towards formalising arrangements with other authorities to be part of a British Wealth Fund as agreed in recommendations (a) and (b) above; and

   ii. Respond to the government's consultation 'Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulation 2009'.

Background Papers

None

Appendices

Appendix 1 - Local Government Pension Scheme: Investment Reform Criteria and Guidance'.

Appendix 2 - Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies

Appendix 3 - Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009.

Equal Opportunities Implications

None specific

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Department for
Communities and
Local Government

Local Government Pension Scheme: Investment Reform Criteria and Guidance

November 2015
Department for Communities and Local Government

This document/publication is also available on our website at www.gov.uk/dclg

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Ministerial Foreword

At the summer Budget 2015, the Chancellor announced our intention to invite administering authorities to bring forward proposals for pooling Local Government Pension Scheme investments, to deliver significantly reduced costs while maintaining overall investment performance.

We have been clear for some time that the existing arrangements for investment by the Local Government Pension Scheme are in need of reform, and the announcement made plain our expectation that authorities would be ambitious when developing their proposals. The publication of these criteria and their supporting guidance marks a significant milestone on the road to reform, placing authorities in a strong position to take the initiative and drive efficiencies in the Scheme, and ultimately deliver savings for local taxpayers.

The Scheme is currently organised through 89 separate local government administering authorities and a closed Environment Agency scheme, which each manage and invest their assets largely independently. Recognising the potential for greater efficiency in this system, the coalition government first began to consider the opportunity for collaboration in 2013 with a call for evidence. Since then, we have been exploring the opportunities to improve; gathering evidence, testing proposals, and listening to the views of administering authorities and the fund management industry.

The Chancellor's announcement draws on this earlier work and in particular the consultation, *Opportunities for collaboration, cost savings and efficiencies,* published in May 2014 by the coalition government. More than 200 consultation responses and papers were received and analysed, leading to the development of a framework for reform that has administering authorities at its centre. The criteria published today make clear the Government's expectation for ambitious proposals for pooling, and invite authorities to lead the design and implementation of their own pools. The criteria have been shaped and informed by earlier consultations, as well as several conversations with administering authorities and the fund management industry which took place over the summer.

Working together, authorities have a real opportunity to realise the benefits of scale that should be available to one of Europe's largest funded pension schemes. The creation of up to six British Wealth Funds, each with at least £25bn of Scheme assets, will not only drive down investment costs but also enable the authorities to develop the capacity and capability to become a world leader in infrastructure investment and help drive growth. I know that many authorities have already started to consider who they will work with and how best to achieve the benefits of scale. These early discussions place those authorities on a strong footing to deliver against our criteria, and I look forward to seeing their proposals develop over the coming months.

Marcus Jones

Criteria

1.1 In the July Budget 2015, the Chancellor announced the Government's intention to work with Local Government Pension Scheme (the Scheme) administering authorities to ensure that they pool investments to significantly reduce costs while maintaining overall investment performance. Authorities are now invited to submit proposals for pooling which the Government will assess against the criteria in this document. The Chancellor has announced that the pools should take the form of up to six British Wealth Funds, each with assets of at least £25bn, which are able to invest in infrastructure and drive local growth.

1.2 The following criteria set out how administering authorities can deliver against the Government's expectations of pooling assets.

1.3 It will be for authorities to suggest how their pooling arrangements will be constituted and will operate. In developing proposals, they should have regard to each of the four criteria, which are designed to be read in conjunction with the supporting guidance that follows. Their submissions should describe:

A. **Asset pool(s) that achieve the benefits of scale:** The 90 administering authorities in England and Wales should collaborate to establish, and invest through asset pools, each with at least £25bn of Scheme assets. The proposals should describe these pools, explain how each administering authority's assets will be allocated among the pools, describe the scale benefits that these arrangements are expected to deliver and explain how those benefits will be realised, measured and reported. Authorities should explain:

- The size of their pool(s) once fully operational.
- In keeping with the supporting guidance, any assets they propose to hold outside the pool(s), and the rationale for doing so.
- The type of pool(s) they are participating in, including the legal structure if relevant.
- How the pool(s) will operate, the work to be carried out internally and services to be hired from outside.
- The timetable for establishing the pool(s) and moving their assets into the pool(s). Authorities should explain how they will transparently report progress against that timetable.

B. **Strong governance and decision making:** The proposed governance structure for the pools should:

i. At the local level, provide authorities with assurance that their investments are being managed appropriately by the pool, in line with their stated investment strategy and in the long-term interests of their members;

ii. At the pool level, ensure that risk is adequately assessed and managed, investment implementation decisions are made with a long-term view, and a culture of continuous improvement is adopted.

Authorities should also revisit their internal processes to ensure efficient and effective decision making and risk management, while maintaining appropriate democratic accountability. Authorities should explain:

- The governance structure for their pool(s), including the accountability between the pool(s) and elected councillors, and how external scrutiny will be used.
- The mechanisms by which the authority can hold the pool(s) to account and secure assurance that their investment strategy is being implemented effectively and their investments are being well managed.
- Decision making procedures at all stages of investment, and the rationale underpinning this.
- The shared objectives for the pool(s), and any policies that are to be agreed between participants.
- The resources allocated to the running of the pool(s), including the governance budget, the number of staff needed and the skills and expertise required.
- How any environmental, social and corporate governance policies will be handled by the pool(s).
- How the authorities will act as responsible, long term investors through the pool(s), including how the pool(s) will determine and enact stewardship responsibilities.
- How the net performance of each asset class will be reported publically by the pool, to encourage the sharing of data and best practice.
- The extent to which benchmarking is used by the authority to assess their own governance and performance and that of the pool(s), for example by undertaking the Scheme Advisory Board's key performance indicator assessment.

C. **Reduced costs and excellent value for money:** In addition to the fees paid for investment, there are further hidden costs that are difficult to ascertain and so are rarely reported in most pension fund accounts. To identify savings, authorities are expected to take the lead in this area and report the costs they incur more transparently. Proposals should explain how the pool(s) will deliver substantial savings in investment fees, both in the near term and over the next 15 years, while at least maintaining overall investment performance.

Active fund management should only be used where it can be shown to deliver value for money, and authorities should report how fees and net performance in each listed asset class compare to a passive index. In addition authorities should consider setting targets for active managers which are focused on achieving risk-adjusted returns over an appropriate long term time period, rather than solely focusing on short term performance comparisons.

As part of their proposals, authorities should provide:

- A fully transparent assessment of investment costs and fees as at 31 March 2013.
- A fully transparent assessment of current investment costs and fees, prepared on the same basis as 2013 for comparison.
- A detailed estimate of savings over the next 15 years.

- A detailed estimate of implementation costs and when they will arise, including transition costs as assets are migrated into the pool(s), and an explanation of how these costs will be met.
- A proposal for reporting transparently against their forecast transition costs and savings, as well as how they will report fees and net performance.

D. **An improved capacity to invest in infrastructure:** Only a very small proportion of Local Government Pension Scheme assets are currently invested in infrastructure; pooling of assets may facilitate greater investment in this area. Proposals should explain how infrastructure will feature in authorities' investment strategies and how the pooling arrangements can improve the capacity and capability to invest in this asset class. Authorities should explain:

- The proportion of their fund currently allocated to infrastructure, both directly and through funds, or "fund of funds".
- How they might develop or acquire the capacity and capability to assess infrastructure projects, and reduce costs by managing any subsequent investments directly through the pool(s), rather than existing fund, or "fund of funds" arrangements.
- The proportion of their fund they intend to invest in infrastructure, and their ambition in this area going forward, as well as how they have arrived at that amount.

Addressing the criteria

Requirements and Timetable

2.1 Authorities are asked to submit their initial proposals to the Government to LGPSReform@communities.gsi.gov.uk by 19 February 2016. Submissions should include a commitment to pooling and a description of their progress towards formalising their arrangements with other authorities. Authorities can choose whether to make individual or joint submissions, or both, at this first stage.

2.2 Refined and completed submissions are expected by 15 July 2016, which fully address the criteria in this document, and provide any further information that would be helpful in evaluating the proposals. At this second stage, the submissions should comprise:

- for each pool, a joint proposal from participating authorities setting out the pooling arrangement in detail. For example, this may cover the governance structures, decision-making processes and implementation timetable; and
- for each authority, an individual return detailing the authority's commitment to, and expectations of, the pool(s). This should include their profile of costs and savings, the transition profile for their assets, and the rationale for any assets they intend to hold outside of the pools in the long term.

Assessing the proposals against criteria

2.3 The Government will continue to engage with authorities as they develop their proposals for pooling assets over the coming months. The initial submissions will be evaluated against the criteria, with feedback provided to highlight areas that may fall outside of the criteria, or where additional evidence may be required.

2.4 Once submitted, the Government will assess the final proposals against the criteria. A brief report will be provided in response, setting out the extent to which the criteria have been met and highlighting any aspects of the guidance that the Government believes have not been adequately addressed. In the first instance, the Government will work with authorities who do not develop sufficiently ambitious proposals to help them deliver a more cost effective approach to investment that draws on the benefits of scale. Where this is not possible, the Government will consider how else it can drive value for money for taxpayers, including through the use of the "backstop" legislation, should this be in place following the outcome of the consultation described below.

Transitional arrangements

2.5 Plans should be made to transfer assets to the pools as soon as practicable. Analysis commissioned by the Government from PricewaterhouseCoopers (PwC) indicates that, even those pooling mechanisms requiring supporting infrastructure, such as collective investment vehicles, could be established within 18 months. It is expected that liquid assets are transferred into the pools over a relatively short timeframe, beginning from April 2018. It is recognised that illiquid assets are likely to transition over a longer period of time. For the avoidance of doubt, investments with high penalty costs for early exit should not be wound up early on account of the pooling arrangements, but should be transferred across as soon as practicable, taking into account value for money considerations. Any assets that are held outside of the pool should be kept under review to ensure that arrangement continues to provide value for money.

2.6 While authorities will need to be mindful of their developing pooled approach, they should continue to manage both their investment strategies and manager appointments as they do now until the new arrangements are in place. In keeping with the investment regulations, they are still responsible for keeping both under regular review.

Support to develop proposals

2.7 To help authorities develop proposals quickly and efficiently, the Government has made available PwC's detailed technical analysis of the different collective investment vehicles and their tax arrangements at: https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance. This paper is provided for information only. It does not represent the view of Government, and authorities should seek professional advice as needed when developing their proposals. Authorities are also strongly encouraged to learn from those who have already begun to develop collective investment vehicles, such as the London Boroughs or Lancashire and the London Pension Fund Authority.

Legislative context

2.8 At the July Budget 2015, the Chancellor also announced the Government's intention to consult on "backstop" legislation that would require those administering authorities who do not come forward with sufficiently ambitious proposals to pool their assets with others. That consultation has now been published and is available on the Government's website at: https://www.gov.uk/government/consultations/revoking-and-replacing-the-local-government-pension-scheme.

2.9 The consultation proposes to introduce a power for the Secretary of State to intervene in the investment function of an administering authority where it has not had sufficient regard to guidance published by the Secretary of State. The intervention should be proportionate and subject to both consultation and review.

2.10 The draft regulations include a provision for the Secretary of State to issue guidance. Subject to the outcome of the consultation, authorities would then need to have regard to that guidance when producing their investment strategy. The Government proposes to issue this document as Secretary of State's guidance if the draft regulations come into effect. The guidance will be kept under review and may be updated, for example if the proposals for pooling that come forward are not sufficiently ambitious.

2.11 The consultation also proposes to replace and update the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 to make significant investment through pooled vehicles possible.

Supporting guidance

3.1 This guidance is to assist authorities in the design of ambitious proposals for pooling investments and to provide ongoing support as they seek to ensure value for money in the long term. It will be kept under review to ensure that it continues to represent best practice.

A. Asset pool(s) that achieve the benefits of scale

Headline criterion: The 90 administering authorities in England and Wales should collaborate to establish, and invest through asset pools, each with at least £25bn of Scheme assets. The proposals should describe these pools, explain how each administering authority's assets will be allocated among the pools, describe the scale benefits that these arrangements are expected to deliver and explain how those benefits will be realised, measured and reported.

3.2 The consultation, *Opportunities for collaboration, cost savings and efficiencies*, set out strong evidence that demonstrated how using collective investment vehicles and pooling investments can deliver substantial savings for the Local Government Pension Scheme without affecting investment performance. Additional advantages to pooling, which should further reduce costs and improve decision making in the long term, include:

- Increasing the range of asset classes to be invested in directly,
- Strengthening the governance arrangements and in-house expertise available to authorities,
- Improving transparency and long-term stewardship, and
- Facilitating better dissemination of best practice and performance data between authorities.

The case for collective investment

3.3 Published in May 2014, the analysis in the Hymans Robertson report evidenced that using collective investment vehicles could deliver savings. In the case of illiquid assets alone, they found that £240m a year could be saved if investments were channelled through a Scheme wide collective investment vehicle rather than the existing "fund of funds" approach.[1]

3.4 A review of the academic analysis available also supports the case for larger investment pools. For example, Dyck and Pomorski's paper, *Is Bigger Better? Size and performance in pension fund management*, established that larger pension funds were able to operate at lower cost than their smaller counterparts, through a combination of

[1] Hymans Robertson report: *Local Government Pension Scheme structure analysis,* p.3 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/307926/Hymans_Robertson_report.pdf

improved negotiating power, greater use of in-house management, and more cost effective access to alternative assets like infrastructure.[2]

> A third to a half of the benefits of size come through cost savings realized by larger plans, primarily via internal management. Up to two thirds of the economies come from substantial gains in both gross and net returns on alternatives.

3.5 A number of respondents to the May 2014 consultation also set out the case for larger funds being able to access lower cost investments. London Councils, for example, estimated that savings of £120m a year could be delivered if £24bn was invested through the London collective investment vehicle (CIV), as a result of reduced investment management fees, improved performance, and enhanced efficiency.

3.6 Formal mechanisms of pooling, such as collective investment vehicles, offer additional benefits to alternative arrangements such as procurement frameworks. For example, Hymans Robertson explained that larger asset pools would increase the opportunities for buy and sell transactions to be carried out within the Scheme, reducing the need to go to the market and so minimising transaction costs. Their analysis found that this could reduce transaction costs, which erode the value of assets invested, by £190m a year.[3]

3.7 Pooling investments will also create an opportunity to improve transparency and information sharing amongst authorities. By having a single entity responsible for negotiating with fund managers and reporting performance, authorities can see what they are paying and generating in returns and how it compares with other authorities. Similarly, Lancashire County Pension Fund and the London Pension Fund Authority, who are developing a pool for assets and liabilities, anticipate economies of scale driving improved performance. They have recently estimated that by pooling they can achieve enhanced investment outcomes of £20-£30m a year from their current levels.[4]

Achieving appropriate scale

3.8 The Government expects all administering authorities to pool their investments to achieve economies of scale and the wider benefits of sharing best practice.

3.9 A move to larger asset pools would also be in keeping with international experience. For example, in Ontario, smaller public sector pension funds are being required to come together to form pools of around $50bn Canadian (approximately £30bn at the time the proposal was made). Similarly, Australian pension funds have been consolidating in recent years, where a formal review in 2010 recommended that each MySuper pension fund be required to consider annually whether they have sufficient scale and membership to continue as a separate pension fund.[5]

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[2] Dyck and Pomorski, *Is bigger better? Size and Performance in Pension Plan Management*, pp.14-15
[3] Hymans Robertson report, pp.14-15
[4] Sir Merrick Cockell, writing in the *Pensions Expert* on 30 September 2015
[5] Government Response to the Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System, Recommendation 1.6,

3.10 The May 2014 consultation sought views on the number of collective investment vehicles to be established. Respondents stressed the importance of balancing the need for scale with local input and practical governance arrangements. It was also argued that while larger asset pools would deliver greater savings, the potential difficulties of successfully investing large volumes of assets in a single asset class, particularly active strategies for listed assets, should also be taken into account. However, while individual managers may restrict the value of assets they are prepared to accept or are able to invest, the selection of a few managers for each asset class would help to mitigate this risk.

3.11 Having reflected on the views expressed in response to the consultation and the experience of pension funds internationally, the Government believes that in almost all cases, fewer, larger assets pools will create the conditions for lower costs and reduce the likelihood of activity being duplicated across the Scheme, for example by minimising pooled vehicle set-up and running costs. It therefore expects authorities to collaborate and invest through no more than six large asset pools, each with at least £25bn of Local Government Pension Scheme assets under management once fully operational.

3.12 However, the Government recognises that there may be a limited number of bespoke circumstances where an alternative arrangement may be more appropriate for a particular asset class or specific investment. As set out below, this may include pooling to invest in illiquid assets like infrastructure, direct holdings in property and locally targeted investments.

Investment in infrastructure and other illiquid or alternative assets

3.13 The Hymans Robertson report highlighted illiquid or alternative assets as an area for significant savings for the Scheme. They found that in 2012-2013, illiquid asset classes like private equity, hedge funds and infrastructure represented just 10% of investments made, but 40% of investment fees. They also demonstrated that changing the way these investments are made, moving away from "fund of funds" to a collective investment vehicle, could save £240m a year.[6]

3.14 The Government expects the pooling of assets to remove some of the obstacles to investing in these asset classes in a cost effective way. A separate criterion has been included on infrastructure, although similar benefits exist for other alternative or illiquid assets, such as private equity, venture capital, debt funds and new forms of alternative business finance. In light of this, authorities should consider how best to access these asset classes in a more cost-effective way. Regionally based pools, such as the London boroughs' collective investment vehicle, would allow authorities to make best use of existing relationships, while a single national pool for infrastructure or illiquid assets would deliver even greater scale and opportunity for efficiency.

3.15 A considerable shift in asset allocation would be needed to develop a pool of £25bn for investment in infrastructure and other illiquid or alternative assets, such as private equity or venture capital. The Government recognises that such a significant movement in

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http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government_response/recommendation_response_chapter_1.htm

[6] Hymans Robertson report, p.24

asset allocation is unlikely in the near term. As such, should authorities elect to develop a single asset pool for illiquid investments or infrastructure, the Government recognises that a value of assets under management less than £25bn might be appropriate.

Investments outside of the pools

3.16 The Government's presumption is that all investments should be made through the pool, but we recognise that there may be a limited number of existing investments that might be less suitable to pooled arrangements, such as local initiatives or products tailored to specific liabilities. Authorities may therefore wish to explore whether to retain a small proportion of their existing investments outside of the pool, where this can demonstrate clear value for money. Any exemptions should be minimal and must be set out in the pooling proposal, alongside a supporting rationale.

Property

3.17 As of the 31 March 2014, authorities reported that they were investing around 2.5% of their assets in directly held property, with a further 4.1% invested through property investment vehicles.[7] However, the amount invested varies considerably between authorities, with some targeting investment of around 10% of their assets in direct holdings, for example.

3.18 A number of consultation responses stressed the importance of retaining direct ownership of property outside of any pooled arrangement, a view echoed in our discussions with interested parties over the summer. Directly held property is used by some authorities to match a particular part of an authority's liabilities, or to generate regular income. If these assets were then pooled, while the authority would receive the benefits of the pooled properties, there is a risk that this would not match the liability or cash-flow requirements that had underpinned the decision to invest in a particular property.

3.19 In light of the arguments brought forward by authorities and the fund management industry, the Government is prepared to accept that some existing property assets might be more effectively managed directly and not through a pool at present. However, pools should be used if new allocations are made to property, taking advantage of the opportunity to share the costs associated with the identification and management of suitable investments.

3.20 Where authorities invest more than the reported Scheme average of 2.5% in property directly, they should make this clear in their pooling submission.

Addressing the criterion

3.21 When developing their proposals for pooling, authorities should set out:

- The size of their pool(s) once fully operational.
- In keeping with the supporting guidance, any assets they propose to hold outside the pool(s), and the rationale for doing so.

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[7] Scheme Advisory Board, Annual Report http://www.lgpsboard.org/index.php/investment-performance-2014

- The type of pool(s) they are participating in, including the legal structure if relevant.
- How the pool(s) will operate, the work to be carried out internally and services to be hired from outside.
- The timetable for establishing the pool(s) and moving their assets into the pool(s). Authorities should explain how they will transparently report progress against that timetable.

B. Strong governance and decision making

Headline criterion: The proposed governance structure for the pools should:

i. At the local level, provide authorities with assurance that their investments are being managed appropriately by the pool, in line with their stated investment strategy and in the long-term interests of their members;

ii. At the pool level, ensure that risk is adequately assessed and managed, investment implementation decisions are made with a long-term view, and a culture of continuous improvement is adopted.

Authorities should also revisit their internal processes to ensure efficient and effective decision making and risk management, while maintaining appropriate democratic accountability.

3.22 A number of consultation responses stressed the importance of establishing strong governance arrangements for pools. Securing the right balance between local input and timely, effective decision making was viewed as essential, but also a significant challenge. The management and governance arrangements of each pool will inevitably be defined by the needs of those participating. However, there are some underlying principles that the Government believes should be incorporated.

Maintaining democratic accountability

3.23 The May 2014 consultation was underpinned by the principle that asset allocation should remain with the administering authorities. Consultation respondents were strongly in favour of retaining local asset allocation, noting that each fund has a unique set of participating employers, liabilities, membership and cash-flow profiles, which need to be addressed by an investment strategy tailored to those particular circumstances.

3.24 Respondents also highlighted the transparency and accountability benefits offered by local asset allocation. If councillors are responsible for setting the investment strategy, then local taxpayers, who in part fund the Scheme through employer contributions, have an opportunity to hold their decisions directly to account through local elections. As one consultation response explained:

> The accountability of Members of the employing authorities playing a part in deciding locally how the assets of the Pension Fund are allocated is important. Employer contributions are paid, in the main, by local council tax payers who in turn vote for their local councillors. Those councillors should have the autonomy to make decisions relating to the investment strategy of that Pension Fund.

3.25 The Government agrees that this democratic link is important to the effective running of the Scheme and should not be wholly removed by the pooling of investments. As set out below, determining the investment strategy and setting the strategic asset allocation should remain with individual authorities. When developing a pool, authorities should ensure that there remains a clear link through the governance structure adopted, between the pool and the pensions committee. For example, this might take the form of a shareholding in the pool for the authority, which is exercised by a member of the pension committee.

Strategic asset allocation

3.26 Establishing the right investment strategy and strategic asset allocation is crucial to optimising performance. It is increasingly accepted that strategic asset allocation is one of the main drivers of investment returns, having far greater an impact than implementation decisions such as manager selection.

3.27 The majority of respondents to the May 2014 consultation supported local asset allocation, but discussions with interested parties over the summer have highlighted a lack of consensus as to what constitutes strategic asset allocation. Definitions have ranged from selecting high level asset classes such as the proportions in bonds, equities and property; to developing a detailed strategy setting out the extent and types of investments in each of the different equity or bond markets.

3.28 Informed by these discussions with fund managers and administering authorities, the Government believes that pension committees should continue to set the balance between investment in bonds and equities, recognising their authority's specific liability and cash-flow forecasts. Beyond this, it will be for each pool to determine which aspects of asset allocation are undertaken by the pool and which by the administering authority, having considered how best to structure decision making in order to deliver value for money. Authorities will need to consider the additional benefits of centralising decision making to better exploit synergies with other participating authorities' allocations and further drive economies of scale. When setting out their asset allocation authorities should be as transparent as possible, for example making clear the underlying asset class sought when using pooled funds.

Effective and timely decision making

3.29 Authorities should draw a distinction between locally setting the strategic asset allocation and centrally determining how that strategy is implemented. The Government expects that implementation of the investment strategy will be delegated to officers or the pool, in order to make the most of the benefits of scale and react efficiently to changing market conditions. As one consultation response suggested:

> We believe that high-level decisions about Fund objectives, strategy and allocation are best made by individual Funds considering their better knowledge of their liabilities, risk and return objectives and cash flow requirements. More detailed asset allocation decisions should however be centralised to achieve better economies of scale, and to allow more specialist management.

3.30 Authorities will need to revisit and review their decision-making processes as part of their move towards pools. For example, in order to maximise savings, manager selection will need to be undertaken at the pool level. Centralising manager selection would allow the pool to rationalise the number of managers used for a particular asset class. The resulting larger mandates should then allow the pool to negotiate lower investment fees. This approach would also give local councillors more time to dedicate to the fundamental issue of setting the overarching strategy.

3.31 A number of authorities have already delegated hiring and dismissing mangers to a sub-committee comprised predominantly of officers. This has allowed these authorities to react more quickly to changes in the market, taking advantage of opportunities as they arise. Similarly, delegating implementation decisions to the pool will allow the participating authorities to benefit not only from more streamlined decision making, but also from effecting those decisions at scale.

3.32 The creation of pools will necessarily lead to a review of decision making within each authority. The Government expects to see greater consolidation where possible. However, as a minimum, we would expect to see the selection of external fund managers and the implementation of the investment strategy to be carried out at the pooled level.

Responsible investment and effective stewardship

3.33 In June 2011, the Government invited Professor John Kay to conduct a review into UK equity markets and long-term decision making. The Kay Review considered how well equity markets were achieving their core purposes: to enhance the performance of UK companies and to enable savers to benefit from the activity of these businesses through returns to direct and indirect ownership of shares in UK companies. The review identified that short-termism is a problem in UK equity markets.[8]

3.34 Professor Kay recommended that Company directors, asset managers and asset holders adopt measures to promote both stewardship and long-term decision making. In particular, he stressed that 'asset managers can contribute more to the performance of British business (and in consequence to overall returns to their savers) through greater involvement with the companies in which they invest.'[9] He concludes that adopting such responsible investment practices will prove beneficial for investors and markets alike.

3.35 In practice, responsible investment could involve making investment decisions based on the long term, as well as playing an active role in corporate governance by exercising shareholder voting rights. Administering authorities will want to consider the findings of the Kay Review when developing their proposals, including what governance procedures and mechanisms would be needed to facilitate long term responsible investing and stewardship through a pool. The UK Stewardship Code, published by the Financial Reporting Council, also provides authorities with guidance on good practice in terms of monitoring, and engaging with, the companies in which they invest.

Enacting an environmental, social and corporate governance policy

3.36 The investment regulations currently require authorities to set out within the statement of investment principles the extent to which social, environmental or corporate governance considerations are taken into account in the selection, retention and realisation of investments. The draft regulations published alongside this document do not propose to amend this principle.

3.37 These policies should be developed in the context of the liability profile of the Scheme, and should enhance the authority's ability to manage down any funding deficit and ensure that pensions can be paid when due. Indeed, environmental, social and

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[8] *The Kay Review of UK Equity Markets and Long-Term Decision Making*, pp. 9-10
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf

[9] The Kay Review, p.12

corporate governance policies provide a useful tool in managing financial risk, as they ensure that the wider risks associated with the viability of an investment are fully recognised.

3.38 As the Law Commission emphasised in its 2014 report on the fiduciary duty of financial intermediaries, the law generally is clear that schemes should consider any factors financially material to the performance of their investments, including social, environmental and corporate governance factors, and over the long-term, dependent on the time horizon over which their liabilities arise.

3.39 The Law Commission also clarified that, although schemes should make the pursuit of a financial return their predominant concern, they may take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision.

3.40 The Government's intention is to issue guidance to authorities to clarify that such considerations should not result in policies which pursue municipal boycotts, divestments and sanctions, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government. Investment policies should not be used to give effect to municipal foreign or munitions policies that run contrary to Government policy.

3.41 Authorities will need to determine how their individual investment policies will be reflected in the pool. They should also consider how pooling could facilitate implementation of their environmental, social and corporate governance policy, for example by sharing best practice, collaborating on social investments to reduce cost or diversify risk, or using their scale to improve capability in this area.

Addressing the criterion

3.42 When developing their proposals for pooling, authorities will need to set out:

- The governance structure for their pool(s), including the accountability between the pool(s) and elected councillors, and how external scrutiny will be used.
- The mechanisms by which the authority can hold the pool(s) to account and secure assurance that their investment strategy is being implemented effectively and their investments are being well managed.
- Decision making procedures at all stages of investment, and the rationale underpinning this.
- The shared objectives for the pool(s), and any policies that are to be agreed between participants.
- The resources allocated to the running of the pool(s), including the governance budget, the number of staff needed and the skills and expertise required.
- How any ethical, social and corporate governance policies will be handled by the pool(s).
- How the authorities will act as responsible, long term investors through the pool(s), including how the pool(s) will determine and enact stewardship responsibilities.

- How the net performance of each asset class will be reported publically by the pool, to encourage the sharing of data and best practice.

- The extent to which benchmarking is used by the authority to assess their own governance and performance and that of the pool(s), for example by undertaking the Scheme Advisory Board's key performance indicator assessment.

C. Reduced costs and excellent value for money

Headline criterion: In addition to the fees paid for investment, there are further hidden costs that are difficult to ascertain and so rarely reported in most pension fund accounts. To identify savings, authorities are expected to take the lead in this area and report the costs they incur more transparently. Proposals should explain how the pool(s) will deliver substantial savings in investment fees, both in the near term and over the next 15 years, while maintaining overall investment performance.

Active fund management should only be used where it can be shown to deliver value for money, and authorities should report how fees and net performance in each listed asset class compare to a passive index. In addition authorities should consider setting targets for active managers which are focused on achieving risk-adjusted returns over an appropriate long term time period, rather than solely focusing on short term performance comparisons.

3.43 As set out in the July Budget 2015 announcement, the Government wants to see authorities bring forward proposals to reform the way their pension scheme investments are made to deliver long-term savings for local taxpayers. Authorities are invited to consider how they might best deliver value for money, minimising fees while maximising overall investment returns.

Scope for savings

3.44 Pooling investments offers an opportunity to share knowledge and reduce external investment management fees, as the fund manager is able to treat the authorities as a single client. There is already a considerable body of evidence in the public domain to support authorities in developing their proposals for investment reform and this continues to grow with new initiatives emerging from local authorities:

- **Passive management:** Hymans Robertson showed that annual fee savings of £230m could be found by moving from active to passive management of listed assets like bonds and equities, without affecting the Scheme's overall return.[10]
- Their analysis suggested that since passive management typically results in fewer shares being traded, turnover costs, which are a drag on the performance achieved through active management, might be reduced by £190m a year.[11]
- **Collective investment:** Hymans Robertson also demonstrated that £240m a year could be saved by using a collective investment vehicle instead of "fund of funds" for illiquid assets like infrastructure, hedge funds and private equity.[12]
- Similarly, the London Pension Fund Authority has estimated that they have reduced their external manager fees by 75% by bringing equity investments in-house, and hope to expand this considerably as part of their collective investment vehicle with Lancashire County Pension Fund.[13]

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[10] Hymans Robertson report, p. 12
[11] Hymans Robertson report, pp. 14-15
[12] Hymans Robertson report, p. 3
[13] Chris Rule, LPFA Chief Investment Officer, reported in *Pension Expert* on 1 October 2015

- **Sharing services and procurement costs:** The National Procurement Framework has also helped authorities to address some of the other costs associated with investment, such as legal and custodian fees, reporting measurable savings of £16m so far.[14]

3.45 As Hymans Robertson's analysis shows, just tackling the use of "fund of funds" for illiquid assets like infrastructure could save around £240m a year, with clear opportunities to go further. It is in this context that the Government is encouraging authorities to bring forward their proposals for collaboration and cost savings. Although a particular savings target has not been set, the Government does expect authorities to be ambitious in their pursuit of economies of scale and value for money.

In-house management

3.46 Some authorities manage all or the majority of their assets internally and so can already show very low management costs. In these cases, a move to a collective investment vehicle with external fund managers is unlikely to deliver cost savings from investment fees alone. However, there are wider benefits of collaboration which authorities with in-house teams should consider when developing their proposals for pooling. A pool of internally managed assets could lead to further reductions in costs, for example by sharing staff, research and due diligence checks; it may improve access to staff with stronger expertise in particular asset classes; and could introduce greater resilience in staff recruitment, retention and succession planning. Alternatively, newly created pools might wish to work with existing in-house teams to build up expertise and take advantage of their lower running costs.

Active and passive management

3.47 The May 2014 consultation considered the use of active and passive management by the Local Government Pension Scheme. Active management attempts to select fund managers who actively choose a portfolio of assets in order to deliver a return against a specific investment target. In practice, this is often used to try and outperform a benchmark, for that class of assets over a specific period. In contrast, passive management tracks a market and aims to deliver a return in line with that market.

3.48 The consultation demonstrated that when considered in aggregate, the Scheme had been achieving a market return over the last ten years in each of the main equity markets. This suggested that collectively the Scheme could have delivered savings by using less costly passive management for listed assets like bonds and equities, without affecting overall performance. While the majority of consultation responses agreed that there was a role for passive management in a balanced portfolio, most also argued that authorities should retain the use of active management where they felt it would deliver higher net returns.

3.49 In response to that consultation, the Government has now invited authorities to bring forward proposals for pooling investments to deliver economies of scale. The extent to which passive management is used will remain a decision for each authority or pool,

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[14] National LGPS Frameworks website, http://www.nationallgpsframeworks.org/national-lgps-frameworks-win-lgc-investment-award

based on their investment strategy, ongoing performance and ability to negotiate lower fees with fund managers. However, in light of the evidence set out in the Hymans Robertson report and the May 2014 consultation, authorities are encouraged to keep their balance of active and passive management under review to ensure they are delivering value for money. For example, should their net returns compare poorly against the index in a particular asset class over the longer term, authorities should consider whether they are still securing value for money for taxpayers and Scheme members.

3.50 When determining how to measure performance, authorities are encouraged to consider setting targets for active managers that are focused on achieving risk-adjusted returns over an appropriate long term time period, rather than solely focusing on short term performance comparisons.

Improving the transparency of costs

3.51 In addition to the fees paid to asset managers, there are considerable hidden costs of investment that are difficult to identify and so often go unreported by investors. In the case of the Local Government Pension Scheme, Hymans Robertson showed that investment costs in 2012-13 were at least £790m a year, in contrast to the £409m reported by the authorities.[15] Even the £790m understated the total investment costs as it excluded performance fees on alternative assets such as private equity and hedge funds (it included performance fees on traditional assets) and turnover costs (investment performance figures include the impact of turnover costs).

3.52 To really drive savings within the Scheme, it is essential that these hidden costs are better understood and reported as transparently as possible. Although many of these costs are not paid out in cash, they do erode the value of the assets available for investment and so should also be scrutinised and the opportunities for savings explored.

3.53 The Chartered Institute of Public Finance and Accountancy (CIPFA) has already made some changes to their guidance, Accounting for Local Government Pension Scheme management costs 2014, to encourage authorities to explore these costs and report some through a note to the accounts. For example, these include performance fees and management fees on pools deducted at source. Authorities should have regard to this guidance and ensure that they are reporting costs as transparently as possible.

3.54 In addition, the Scheme Advisory Board is commissioning advice to help authorities more accurately assess their transparent and hidden investment costs. Once available, authorities should take full advantage of this analysis when developing their proposals.

Addressing the criterion

3.55 As set out above, there is a clear opportunity for authorities to collaborate to deliver hundreds of millions in savings in the medium term. Although there is no overall savings target for the Scheme, the Government expects authorities to take full advantage of the benefits of pooling to reduce costs while maintaining performance.

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[15] Hymans Robertson report, pp.10-11

3.56 To support the delivery of savings authorities bringing forward proposals are asked to set out their current investment costs in detail, and demonstrate how these will be reduced over time and the savings forecast. Where possible, costs should be reported back to 2012-2013 so that any cost reductions already achieved as a result of procurement frameworks and early fee negotiations are transparently captured.

3.57 Authorities are encouraged to provide:

- A fully transparent assessment of investment costs and fees as at 31 March 2013.
- A fully transparent assessment of current investment costs and fees, prepared on the same basis as 2013 for comparison.
- A detailed estimate of savings over the next 15 years.
- A detailed estimate of implementation costs and when they will arise, including transition costs as assets are migrated into the pool(s), and an explanation of how these costs will be met.
- A proposal for reporting transparently against their forecast transition costs and savings, as well as how they will report fees and net performance.

D. An improved capacity and capability to invest in infrastructure

Headline criterion: Only a very small proportion of Local Government Pension Scheme assets are currently invested in infrastructure; pooling of assets may facilitate greater investment in this area. Proposals should explain how infrastructure will feature in authorities' investment strategies and how the pooling arrangements can improve the capacity and capability to invest in this asset class.

3.58 Investment in infrastructure is increasingly being seen as a suitable option for pension funds, particularly amongst larger organisations. This may in part be the result of the typically long term nature of these investments, which may offer a useful match to the long term liabilities held by pension funds.

International experience

3.59 Multiple large international pension funds are investing a significant proportion of their assets in infrastructure. A recent OECD report, which analysed a sample of global pension funds as at 2012, showed that some Canadian and Australian funds (with total assets of approximately £35-40bn in 2014 terms) were investing up to 10-15% in this asset class.[16] The report also noted that those funds with the largest infrastructure allocations were investing directly, and that such investment was the result of the build up of sector-specific knowledge, expertise and resources.[17] This experience might be demonstrated through an organisation's ability to manage large projects, as well as the associated risk.

3.60 Figures published by the Scheme Advisory Board for the 2013 Annual Report show that around £550m, or 0.3%, of the Scheme's total assets of £180bn was invested in infrastructure.[18] This falls some way behind other large pension funds that have elected to invest in this area, such as those noted above and the Ontario Teachers Pension Plan which invested 6.1% according to the same 2014 report.

Creating the opportunity

3.61 The Scheme's current structure, where assets are locked into 90 separate funds, reduces scale and makes significant direct infrastructure investment more difficult for administering authorities. As a result, authorities may determine that they are unable to invest in infrastructure, or may invest indirectly, through the "fund of funds" structure. Such arrangements are expensive, as the Hymans Robertson report demonstrated and this paper sets out in paragraph 3.13.

3.62 Developing larger investment pools of at least £25bn will make it easier to develop or acquire improved capacity and capability to invest in infrastructure. In so doing, it should be possible to reduce the costs associated with investment in this area. This is likely to be the case particularly if authorities pool their infrastructure investment nationally, where the

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[16] OECD, *Annual Survey of Large Pension Funds: report on pension funds' long-term investments*, p.32, available at: http://www.oecd.org/daf/fin/private-pensions/LargestPensionFunds2012Survey.pdf
[17] OECD report, p.14
[18] Scheme Advisory Board annual report http://www.lgpsboard.org/index.php/scheme-investments

resultant scale may allow them to buy-in or build-up in-house expertise in relevant areas, such as project and risk management.

3.63 In considering such investment, administering authorities might want to reflect on the wide range of assets that might be explored, such as railway, road or other transport facilities; utilities services like water and gas infrastructure; health, educational, court or prison facilities, and housing supply. Authorities should also examine the benefits of both:

- Greenfield infrastructure – projects involving the construction of brand new infrastructure, such as a new road or motorway junction to unlock a housing development, or the recent investment of £25m by the Greater Manchester Pension Fund to unlock new sites and build 240 houses; and
- Brownfield infrastructure – investing in pre-existing infrastructure projects, such as taking over the running of (or the construction of a new terminal building at) an airport.

3.64 As set out above, investment in infrastructure represents a viable investment for pension funds, offering long term returns to match their liabilities. Authorities will need to make their investments based on an assessment of risk, return and fit with investment strategy. However, the creation of large pools will make greater investment in infrastructure a more realistic prospect, opening up new opportunities to develop or buy-in the capacity and capability required.

3.65 In developing their proposals for pooling, authorities should take the opportunity to review their asset allocation decisions and consider how they can be more ambitious in their infrastructure investment. The Government believes that authorities can play a leading role in UK infrastructure and driving local growth, and encourages authorities to compare themselves against the example set by the leading global pension fund investors in their approach to allocating assets in this area.

Addressing the criterion

3.66 Authorities should identify their current allocation to infrastructure, and consider how the creation of up to six pools might facilitate greater investment in this area. When developing proposals, authorities should explain:

- The proportion of their fund currently allocated to infrastructure, both directly and through fund, or "fund of funds".
- How they might develop or acquire the capability and capability to assess infrastructure projects, and reduce costs by managing any subsequent investments directly through the pool(s), rather than existing fund, or "fund of funds" arrangements.
- The proportion of their fund they intend to invest in infrastructure, and their ambition in this area going forward, as well as how they have arrived at that amount.

2

Department for
Communities and
Local Government

Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies

Consultation response

November 2015
Department for Communities and Local Government

This document/publication is also available on our website at www.gov.uk/dclg

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Contents

The consultation

1.1 This paper sets out the Government's response to the consultation, *Opportunities for collaboration, cost savings and efficiency,* which ran from 1 May to 11 July 2014. It outlines the main themes raised by respondents under each question and attempts to capture the wide range of views expressed.

1.2 The consultation set out how the Local Government Pension Scheme (the Scheme) could save up to £660 million a year by investing collaboratively and more efficiently. It sought respondents' views on the proposals for reform and how, if adopted, they might be implemented most effectively.

Background to the consultation

1.3 In 2010, the Government commissioned Lord Hutton to chair the Independent Public Service Pensions Commission to review public service pensions and make recommendations on how they might be made more sustainable and affordable in the long term, while being fair to both taxpayers and public sector workers. Lord Hutton's final report was published on 10 March 2011. The report highlighted the collaborative approach being taken by funds within the Local Government Pension Scheme and recommended that the benefits of co-operative working be investigated further.

1.4 Recognising the scope for potential savings to the Scheme, the Department hosted a round-table event with the Local Government Association to consider these issues in May 2013. The objectives for reform identified at the round-table fed into a call for evidence on the future structure of the Scheme that ran from 21 June to 27 September 2013. This asked respondents to consider how the administration, structure and management of the Scheme might be reformed to reduce fund deficits and improve investment returns, as well as cut investment fees and administration costs, strengthen the availability and quality of in-house resource, and improve the flexibility of investments. A copy of the call for evidence and the Government's response is available at https://www.gov.uk/government/consultations/call-for-evidence-on-the-future-structure-of-the-local-government-pension-scheme.

1.5 The responses were shared with the shadow Scheme Advisory Board, which provided the Minister for Local Government with an analysis of the responses and a number of recommendations. The shadow Board's findings were also published at http://www.lgpsboard.org/index.php/structure-reform/board-analysis-menu.

1.6 The responses to the call for evidence and the recommendations of the shadow Board helped to inform the consultation, *Opportunities for collaboration, cost savings and efficiencies*. In addition, a third piece of analysis was used to shape the proposals, commissioned by the Minister for Local Government and the Minister for the Cabinet Office using the Contestable Policy Fund. Hymans Robertson were chosen to examine three options for reform: creating five to ten merged funds, setting up between five and ten collective investment vehicles (CIVs), or establishing just one collective investment vehicle. This analysis, which identified scope for savings of up to £660 million each year, set out the costs and benefits of each option, the time required to realise any savings, and the practical and legal barriers to implementation. It also included an analysis of Scheme performance over 10 years based on data provided by 98 local government pension schemes to the WM Company Limited. A copy of the Hymans Robertson report is available at https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies.

Summary of proposals

1.7 The consultation, published on 1 May 2014, set out the following package of proposals:

- Establishing collective investment vehicles to provide administering authorities with a mechanism to access economies of scale, helping them to invest more efficiently in listed and alternative assets and to reduce investment costs.
- Significantly reducing investment fees and other costs of investment by using passive management for listed assets, since the aggregate fund performance has been shown to replicate the market.
- Keeping asset allocation with the local fund authorities, and making available more transparent and comparable data to help identify the true cost of investment and drive further efficiencies in the Scheme.
- A proposal not to pursue fund mergers at this time.

1.8 The consultation sought respondents' views on the proposals and how they might be implemented. In particular, interested parties were asked to address the following questions:

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.

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

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

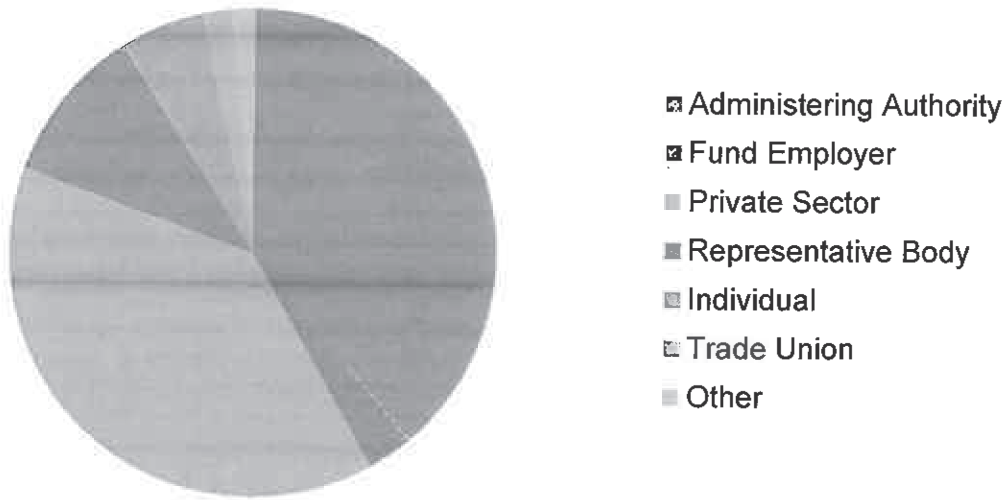
Q5. In light of the evidence on the relative costs and benefits of active and passive management, including Hymans Robertson's evidence on aggregate performance, which of the options set out above offers best value for taxpayers, Scheme members and employers?

1.9 A summary of the responses received is provided for each question in section four. Several submissions also discussed alternative proposals for reform or ideas for reducing the deficit faced by most administering authorities, since the Scheme as a whole has assets to cover around 79 per cent of its liabilities. An overview of these suggestions is also available in section four.

Summary of responses received

2.1 201 responses to the consultation were received in total, with both the public and private sector well represented. A full list of respondents has been included in Annex A.

Administering authorities	78	Representative bodies[1]	21
Private sector organisations	78	Individuals	11
Fund employers	6	Trade Unions	4
Other	3		



2.2 The majority of consultation responses agreed that using collective investment vehicles would deliver savings for the Local Government Pension Scheme. Similarly, there was a broad acceptance that there was a role for passive management in a balanced portfolio of investments, although most respondents felt strongly that neither proposal should be made compulsory.

2.3 However, respondents often differed when considering the detail of the proposals. For example, a wide range of views were put forward as to where collective investment vehicles might add most value, or how they should be organised.

2.4 It was commonly argued that further work was required to develop the policy, including setting out what a viable collective investment vehicle structure might look like. In addition, some respondents suggested that alternative governance, investment and administration reforms should be considered, in order to improve fund performance or address deficits. However, no overarching deficit reduction proposals were put forward.

[1] *Representative bodies* include lobby groups and *Other* includes civil society organisations.

Government response

3.1 As set out in paragraph 2.1, *Opportunities for collaboration, cost savings and efficiencies* attracted a high level of interest from both the public and private sector, with over 200 responses received. It was clear that a great deal of consideration and effort went into these submissions and we are grateful to the individuals and organisations that provided a response.

3.2 The consultation set out the evidence and rationale for pooling investments through collective investment vehicles and using passive management for listed assets like bonds and equities. It sought to open up for discussion the focus of the reforms and to learn from respondents how the proposals might be best implemented.

3.3 In response to this first issue, the focus of the reforms, respondents were broadly in agreement: Mergers should not be pursued; asset allocation should remain with the administering authorities; and collective investment vehicles, at least in some capacity, offered the opportunity to deliver economies of scale. The Government remains of the view that asset allocation should stay with each of the 90 administering authorities and that savings can be delivered through the use of asset pooling, and in particular collective investment vehicles.

3.4 Respondents offered a wider range of views on the question of implementation. However, two common themes emerged:

- The proposals should not be made compulsory;
- A more detailed proposal is required before any final decisions about implementation can be made.

3.5 The Government recognised that further work was required to develop the policy. Indeed, questions three, four and five of the consultation encouraged respondents to shape the policy and suggest what a detailed package of proposals might look like. Many respondents offered their thoughts in this area, discussing the relative advantages and disadvantages of the different types of collective investment vehicle available, or offering suggestions as to the number of vehicles that might be required and how they should be organised.

3.6 In addition to the responses submitted, the Government commissioned PricewaterhouseCoopers (PwC) to analyse how collective investment vehicles could be best structured in terms of ownership and as legal entities. Their report discussed the different types of collective investment vehicle and concluded that the Authorised Contractual Scheme was likely to be the preferred approach. An Authorised Contractual Scheme is a UK based, tax transparent fund that is regulated by the Financial Conduct Authority and is designed to make it easier for the underlying investors to access the correct rate of tax when buying and selling investments. A copy of PwC's report is available at: https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance.

3.7 Having considered the evidence and analysis of the consultation responses, the Government decided to pursue a localised approach to reform, inviting authorities to determine how best to pool their assets and with whom to work. The following announcement was made at the July Budget 2015:

The Government will work with Local Government Pension Scheme administering authorities to ensure that they pool investments to significantly reduce costs, while maintaining overall investment performance. The Government will invite local authorities to come forward with their own proposals to meet common criteria for delivering savings. A consultation to be published later this year will set out those detailed criteria as well as backstop legislation which will ensure that those administering authorities that do not come forward with sufficiently ambitious proposals are required to pool investments.

3.8 Drawing on the consultation responses and discussions with local government and the fund management industry over the summer, the Government has prepared criteria against which the authorities' proposals for pooling will be assessed. Authorities are asked to develop proposals for pooling assets that demonstrate:

- Asset pool(s) that achieve the benefits of scale,
- Strong governance and decision making,
- Reduced costs and excellent value for money, and
- An improved capacity to invest in infrastructure.

3.9 The criteria and supporting guidance have been published and can be found at: https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance.

3.10 A consultation has now been launched on draft regulations that would reform the investment regulations and introduce a power of intervention to allow the Secretary of State to intervene in an authority's investment function should it not bring forward ambitious proposals for pooling. The consultation, Revoking and replacing the Management and Investment of Funds Regulations 2009, is open until 19 February 2016 and available at: https://www.gov.uk/government/consultations/revoking-and-replacing-the-local-government-pension-scheme.

The responses in detail

4.1 This section provides a detailed overview of the consultation responses, with quotations used throughout to illustrate the points raised. It captures the views expressed by respondents, and includes notes to supplement the Government's response.

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.

4.2 Over two-thirds of the respondents that expressed a clear view in reply to this question agreed that collective investment vehicles would, at least in some respects, help the administering authorities to achieve economies of scale and deliver savings. Although opinions varied as to where pooled vehicles could add most value, there was a broad consensus that participation should be voluntary, with administering authorities able to invest elsewhere as well.

Benefits of collaboration and collective investment vehicles

4.3 The benefits of collective investment vehicles were widely discussed, with many responses focusing on the opportunity that larger pooled funds presented to reduce asset manager fees. Lower administration, commission and custodian fees were highlighted, as well as a likely fall in transaction costs. It was thought that smaller administering authorities in particular might benefit from access to a wider selection of managers, thereby improving diversification.

> The two largest investment management costs for LGPS [the Scheme] are investment manager fees and asset servicing costs. These are both fees typically charged as a basis point fee, with the basis point charge reducing as the size of assets increases. Accordingly, by combining assets together in a CIV, this should result in larger average asset sizes per mandate, and so reduce fees. [1 basis point is equal to 0.01% of assets].
>
> Deloitte

4.4 Some respondents argued that collective investment vehicles could improve governance, as administering authorities would be refocused on setting their investment strategy if they were no longer responsible for manager selection. They were also seen as a means of accessing better advice, as competition amongst suppliers could increase if demand for these skills was concentrated into a few vehicles.

4.5 However, several responses called for alternative means of collaboration to be considered. For example, fee negotiations with asset managers could take place as if the funds had been pooled, but without the formal vehicle structure. Alternatively, greater use of performance related fees could both drive down costs and promote performance; while improving governance arrangements and the skills of pension committees was thought to lead to better manager selection and lower turnover costs.

4.6 A few respondents argued that in-house management should play a stronger role, with existing teams offering shared service arrangements to administering authorities not currently using internal fund management, in order to deliver scale and savings. Joint committees were also suggested, so that better performing administering authorities can support weaker ones.

4.7 Respondents also stressed that existing examples of collaboration, like the National LGPS Procurement Framework, have been shown to save both time and money. Some argued that they might offer the advantages of a pooled fund without the cost of the supporting structure.

> Using good quality frameworks saves significant time and money for LGPS [Scheme] Funds, ensures best practice OJEU compliant procurement and provides access to services with proven track record and expertise.
>
> National LGPS Frameworks

4.8 A few submissions highlighted that the existing investment regulations[2] would need to be changed to facilitate substantial investment in collective investment vehicles. They argued that the regulations currently include limits on investment in certain types of investment vehicles which would need to be removed. This follows wider calls for the investment regulations to be reviewed, which have been considered by the Government.

Limitations of Collective Investment Vehicles

4.9 Around 30 respondents queried whether savings would be delivered, especially for larger funds that were thought to already access diverse investments and low fees. Some felt that governance and accountability might be weakened if performance was reported at the group, rather than fund level. The vehicles were also seen as a potential barrier to responding to individual administering authorities' needs; for example if boutique fund managers were excluded or an environmental, social and corporate governance policy was ignored.

> Due to focus on fees and capacity CIVs may limit the number of managers funds can choose from. This may exclude some of the boutique managers many of whom have been proven to deliver favourable outperformance net of fees.
>
> Cumbria Pension Fund

Making best use of collective investment vehicles

4.10 Although there was strong support for collective investment vehicles, opinion was divided over where they would add most value. Some respondents felt that pooled funds should only be used for unlisted investments like hedge funds and private equity, while others argued they were most useful for listed assets like bonds and equities. A brief summary of the main arguments from the different view points is provided below.

4.11 Around ten percent of respondents giving a clear response to this question saw no role for collective investment vehicles if passive management of bonds and equities was adopted. Many felt that they were already paying low fees for passive management, by

[2] The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009

using either existing pooled funds or in-house teams. For those using a large, passive pool, creating a new vehicle just for the local government pension scheme was seen as unfavourable, as it could increase transaction costs and would not have a track record of delivery.

> For passive investment, the use of a framework agreement that would access the pooled funds of the large passive managers should be considered. An LGPS wide fee arrangement could be negotiated. Such funds have extremely efficient trading operations in place and benefit from strong administration practices, transition management skills and a sound approach to corporate governance.
>
> Tyne and Wear Pension Fund

4.12 In contrast, a few respondents argued that pooled funds would not be suitable for actively managed bonds and equities, as investment managers may restrict access to certain opportunities because they cannot invest a larger volume of assets. Meeting individual administering authorities' needs was also seen as problematic as they may have different investment policies, for example some permit stock lending but not all.

4.13 A further ten percent stressed the benefits of pooled vehicles for illiquid assets like private equity, hedge funds and infrastructure. Some argued that administering authorities newly investing in these asset classes could learn from more experienced ones, as well as reducing costs by sharing expertise and due diligence checks. Smaller administering authorities were also thought to benefit, offering access to these types of investments without needing to use more expensive "fund of funds". Similarly, it was suggested that other administering authorities may be able to more easily to build on existing projects and invest in social infrastructure.

> A CIV or any other pooled vehicle for alternative investments could...achieve sufficient scale of pooled assets to establish investments in social infrastructure such as social housing or residential care homes.
>
> Legal and General Investment Management

4.14 However, others felt that a collective investment vehicle for investments like private equity and infrastructure would be less effective, since mangers already operating at capacity would have little incentive to reduce fees. Similarly, it was argued that better performing managers may not want to risk having such a concentrated client base and so may choose not to participate in a vehicle just for the Local Government Pension Scheme.

Practical constraints

4.15 Respondents also raised a range of practical issues they wished to see addressed:

- How would the range of skills required for the different types of illiquid assets like infrastructure, private equity and hedge funds be accommodated?
- Would the cost and availability of the resources and skills required to run a vehicle for these illiquid assets be prohibitive? Especially for private equity, where specialist managers with local knowledge and established relationships in several countries may be required?

- Was there not still a case for accessing private equity through a fund of funds, if it provided a better way to diversify investments and manage risk, especially where an existing structure has a track record of strong delivery?

> It is important to understand that Fund-of-Funds allow access to specialist investment managers... It could, for example, be argued that an investor like ourselves could build our own private equity portfolio given that we have £100m invested in the asset class. However, it is naïve in the extreme to think that we could build one that is both sufficiently diversified and exposed primarily to "top tier" managers across the World...
>
> Leicestershire Pension Fund

4.16 Several respondents argued that property should not be included in a collective investment vehicle with illiquid assets like infrastructure and hedge funds. The resource required to support investment in property was seen as a significant cost and barrier to its involvement in a new pooled fund. In addition, many highlighted that it would be expensive to move property investments into a different vehicle as stamp duty land tax that would be payable, although respondents differed on the amount it would cost.

> However, if ownership of all the £12.1 billion LGPS [Scheme] property assets were transferred to a new vehicle, Stamp Duty Land Tax alone would amount to £486 million.
>
> Association of Real Estate Funds

4.17 A few responses also stressed that the savings identified by Hymans Robertson as resulting from a collective investment vehicle for pooled assets did not include property, which was categorised separately and in some cases held directly. As such, they argued that the savings available from investing in property through a pooled vehicle have yet to be demonstrated.

Government response

4.18 The Government has reflected on the views received and invited administering authorities to bring forward proposals for pooling their pension scheme assets. In so doing, it will be up to authorities to determine the most suitable mechanism for pooling and the extent to which different investment approaches, such as in-house management, should be used.

4.19 The Government has published a consultation on revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. This proposes to remove the existing limits on investments and instead move towards the prudent person approach to securing a diversified investment strategy that appropriately takes account of risk.

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

4.20 There was almost unanimous agreement, amongst those who responded to this question, that asset allocation should remain with the administering authorities. Many felt that this should include implementation style, such as whether to use active or passive management.

Asset allocation should remain with the administering authorities

4.21 Respondents argued that if the liabilities remained with the administering authorities, it was vital that they also kept the means to address them. A locally set investment strategy was seen as essential if an administering authority was to match its investments to its circumstances; including fund maturity, deficit recovery period, cash-flow requirements, the affordability of employer contributions and the desired risk appetite of the administering authority.

4.22 The democratic link to councillors was also emphasised. At present, investment decisions are typically made by councillors through the administering authority's pensions committee. As such, it was argued that those responsible for determining the asset allocation could be held to account directly by council tax payers through local elections.

> The decisions on strategic asset allocation are therefore best taken where those liabilities are best understood and where responsibility lies for the future funding which is at individual Pension Fund level.
>
> An Administering Authority

Some changes could be made

4.23 However, some respondents also called for changes to strengthen local decision making, with high turnover of pension committee membership often cited as an issue. A number of suggestions were made, including more peer-benchmarking to consider risk relative to the administering authority's liabilities and investment strategy, publishing evidence of a timely and credible deficit reduction plan, and allowing larger employers such as district councils a clearer say in how the funds and investments are managed.

4.24 The creation of a permanent, professional investment committee was also put forward. Staffed by officials with some councillor representation, it was suggested that this body could be responsible for day to day decisions like manager selection, with the elected pension committee focusing on the long term funding strategy.

The existing asset allocation process should be reformed

4.25 Respondents did not typically call for centralised asset allocation, although some argued that administering authorities should be required to meet a minimum performance or governance standard, with those falling short obliged to delegate asset allocation to a stronger authority. In addition, a few suggested that asset allocation could be collated amongst administering authorities of a similar size or type. They envisaged delegating the detailed asset allocation, but keeping the strategic decisions about fund objectives and high level asset allocation at a local level. However, views differed as to whether this should be delegated to in-house pension teams who could react quickly to changing market conditions, or centralised through a joint committee to achieve scale and access specialists.

4.26 Merging investment committees or using a Joint Committee structure for a small number of administering authorities was seen as advantageous by some respondents, who felt it would consolidate knowledge and free up staff to monitor fund manager performance. Employers in multiple local government pension schemes were also thought to benefit from this arrangement, as the scale achieved could enable administering authorities to set employer specific investment strategies:

> At present, the majority of Administering Authorities run a single investment strategy with all employers having an equal allocation across the chosen asset classes. Increasing the scale through a Joint Committee allows more potential to run multiple investment strategies which could include a standard allocation plus low and high risk options. Individual employers would then have the choice of allocation to best meet their own circumstances and risk appetite. Increasing scale and running with fewer Committees therefore potentially increases local accountability at employer level, as well as allowing a better match of the liabilities at local employer level with the investment strategy of the fund.
>
> Oxfordshire Pension Fund

Government response

4.27 The Government agrees that strategic asset allocation should remain with the local administering authorities. However, as authorities develop proposals for pooling assets, they will wish to revisit and review their decision making processes. For example, while asset allocation should remain a local decision, manager selection should be undertaken at the pool level to maximise savings.

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?

How many common investment vehicles should be established?

4.28 Around sixty per cent of respondents expressed a clear view in response to this question, with most suggesting a minimum number of vehicles rather than an exact total. Of those respondents, almost three quarters called for more than two pooled vehicles, with a further fifteen per cent arguing for as much flexibility as possible. A small number of respondents reiterated their view that collective investment vehicles were not needed. They felt that if all of the asset classes required were to be included, it would add complexity and cost to the administration and governance arrangements.

A small number are needed

4.29 Around ten per cent of those who responded to this question argued that a small number of vehicles would be most effective, for example between one and three. Having just one vehicle for passive investments was seen as advantageous as it would maximise the opportunities to match buy and sell transactions within the pool, reducing interaction with the market and therefore investment costs. A more diverse range of vehicles was thought to be necessary for illiquid assets like infrastructure and private equity, since different skills and resources would be required for each of these asset classes. This group also warned that replicating the existing range of asset classes and investment styles would lead to a proliferation of ineffective vehicles.

Several collective investment vehicles are required

4.30 However, most respondents were in favour of several collective investment vehicles being created. They felt that national vehicles may leave administering authorities insufficiently involved in decision making, or that the governance arrangements would become unwieldy if all 90 authorities were involved. Respondents were also concerned that too few vehicles would increase the funds' exposure to risk. For example, capacity constraints could arise if managers were unable to invest large sums effectively; while other investors may try to exploit the Scheme, aware that any passive investments would need to be rebalanced within known index rules.

> However, as noted in the Hymans Robertson report, there are diseconomies of scale above a certain size while a natural ceiling exists for certain asset classes. Capacity concerns may influence the competition in the market if only the largest investment houses can service demand, limiting many of the more niche or boutique managers who arguably over time have outperformed the market and are best placed to add value while also limiting the extent to which downward pressure on fees can be applied.
>
> Wiltshire Pension Fund

4.31 For many, a larger number of vehicles offered better diversification of asset manager and lower risk. A few suggested that between five and eight vehicles would be ideal, with some arguing that competition between vehicles may boost performance.

A balanced approach

4.32 Several respondents argued that it was not possible to comment on the number of vehicles required until further work had been done to establish a preferred governance structure and operating model. Others felt that the appropriate number should emerge from the design process, once an optimal size of pooled fund has been determined.

4.33 Balancing the need for strong governance, local accountability and input, along with the desired economies of scale and effective decision making, was also a common theme. Similarly, many thought it essential to balance the savings that could be achieved through scale, with the choice and flexibility required to meet administering authorities' investment needs.

> It is widely believed that funds can be too large and subject to capacity constraints, while if not large enough, then potential savings will be significantly reduced. Also, if the mix of asset classes are too diversified, savings could be limited, if not diversified enough, exposure to risk is magnified and may offer limited appeal...Governance arrangements will need to represent the best interest of its members; however if every local authority that manages a pension fund is keen on making representation in the running of the CIV, this would slow down the decision making process and make governance arrangements unwieldy. Therefore a compromise will need to be found.
>
> Milton Keynes Council

How should the common investment vehicles be organised?

4.34 A wide range of ways to organise collective investment vehicles were suggested:

- Creating a vehicle for each **asset class**. This approach was especially popular for illiquid assets like infrastructure, hedge funds and private equity, given the different skills sets, fee structures and access routes involved.
- Using **geographic** groupings or existing networks to facilitate the vehicles, as London Councils are currently doing for the London boroughs.
- Basing vehicles on **risk appetite, investment approach or index,** to help administering authorities deliver their investment strategy, or environmental, social and corporate governance policy. For example, one vehicle might offer the FTSE4Good; a second might be focused on delivering liquid returns; and a third on liability matching.

4.35 Some respondents argued that the number and structure of any vehicles should be decided by the administering authorities, perhaps in response to a clear set of objectives for collaboration set out by Government.

> The number and type of collaborative investment vehicles should be limited to provide for the benefits of scale but should be allowed to develop organically and consist of multi asset class structures.
>
> Shadow Scheme Advisory Board

4.36 Finally, several respondents argued that whatever arrangements were put in place, they should offer the flexibility to react to emerging techniques and the changing needs of the authorities. Views were split as to whether this flexibility should extend to competition between vehicles. Some saw this as a means of preventing monopolies, encouraging innovation and driving down costs, while others thought it might lead to short term decision making and unnecessary asset turnover.

Which asset classes?

4.37 Around fifteen per cent of respondents listed the asset classes that they thought should be included. Many set out a wide range, while others called for the current array of Scheme investments to be offered. A few went further, arguing that reducing the choice available could increase risk in the Scheme, as the assets would become more concentrated into certain asset classes or invested with fewer managers.

4.38 A wide range of geographical markets and implementation styles for bonds and equities were requested. For example, the option to manage both actively and passively was often mentioned, with passive management to include approaches such as smart beta, target index approaches and enhanced passive. These tools use index tracking like most passive funds, but allow the investor to set certain parameters under which the fund may deviate from the index like an actively managed investment. A substantial range of bonds and gilts were also referenced, to encompass different redemption periods and varied risk appetites. A few respondents also called for liability matching, although some felt that this, and other means of addressing interest rate and inflation risks, required a tailored approach for each administering authority and so should be organised outside of any collective investment vehicle.

4.39 For investments other than bonds and equities, a similarly broad range was proposed. This included infrastructure, real estate, global and UK property, hedge funds, private equity, private debt, diversified growth funds and absolute returns.

Government response

4.40 The published criteria and guidance for investment reform asks administering authorities to develop proposals for asset pools that meet their needs, including determining how the pools are structured and the asset classes to be offered. However, it is important that authorities develop larger asset pools in order to access the benefits of scale. The criteria therefore set out the Government's expectation that authorities will develop proposals for no more than six pools, each with at least £25 billion of Scheme assets.

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

What structure should be used?

4.41 Just under forty per cent of respondents gave a clear view about the legal structure they felt should be adopted, for example a unitised vehicle; a limited liability partnership, or an authorised contractual scheme. Many argued that further analysis was required to determine the most appropriate structure, or commented instead on the characteristics they would like to see included. Of those who did indicate a preferred structure, two thirds were in favour of the Authorised Contractual Scheme, with many pointing to London where work is underway to establish this type of vehicle.

Authorised Contractual Scheme

4.42 An Authorised Contractual Scheme (ACS) is a tax transparent fund based in the UK. Launched by HM Treasury in 2013, it is regulated by the Financial Conduct Authority and designed to make it easier for the underlying investors to access the correct rate of tax when buying and selling investments both in the UK and overseas. It can take different legal forms, operating as a Limited Partnership or as a Qualified Investor Scheme. The relationship between the investors and scheme operator, as well as the use of sub-funds within the vehicle, depends on the legal structure adopted.

4.43 The Authorised Contractual Scheme was the most frequently discussed structure amongst both public and private sector respondents. The London boroughs have chosen to use this model for their collective investment vehicle and many respondents drew on their analysis, highlighting the following benefits:

- Regulation by the Financial Conduct Authority and by UK law,
- The ring-fencing of assets and liabilities, so that investors cannot be called upon to cross-subsidise each other,
- A tax transparent structure enabling administering authorities to access the right rate of withholding tax,
- New rules on stamp duty land tax which is expected to offer further tax benefits, for example, if a particular structure is adopted, transfers between sub-funds would be exempt from that tax.

4.44 Wider benefits were also cited, including the option to have fund managers accountable to joint committees where several administering authorities could be represented; the opportunity to improve the comparability and transparency of fund data; and the potential to use transparent sub-fund performance data to deliver better returns.

> Pooling through an ACS is seen as having particular attractions for pension funds due to its tax treatment, governance structure, and its flexibility when it comes to accessing different asset classes.
>
> Society of London Treasurers

Other options should be considered

4.45 Although the majority focused on the Authorised Contractual Scheme, a few questioned whether it would be the most practical option. For example, the Authorised Contractual Scheme cannot hold units in Unit Linked Life Trusts, which are often used by the administering authorities to access UK Commercial Property or pooled index funds. Similarly, the vehicle was thought to be potentially tax inefficient for property, as transfers into the vehicle would, at the time of the consultation, be subject to stamp duty land tax. A few respondents suggested that if more than one vehicle were to be established, different structures could be used to reflect the varied needs of the distinct asset classes. For example, a limited partnership or closed ended fund might be appropriate for longer term investments that are hard to convert into cash, like infrastructure. Here the lack of easy subscription or redemption of holdings may be beneficial, but for the same reasons, that structure may not be suitable for more liquid asset classes like equity.

> It is, however, important to recognise [that] the current tax legislation result[s] in an ACS structure being potentially attractive for liquid investments such as equity but raises questions around their use for illiquid investments, specifically property if the assets are to be moved in-specie from an existing portfolio into an ACS structure.
>
> Aviva Investors

Further work is needed to determine the most beneficial structure

4.46 A significant proportion of respondents remained undecided about the optimal vehicle structure or felt unable to comment. Many argued that given the complexity of the question, further work was needed to better understand the options before making a decision. For example, they suggested that even if the Authorised Contractual Scheme was chosen for its tax transparency, a further decision about the legal structure would also be needed – should it be a limited partnership or co-ownership scheme; if the latter, should it take the form of a Qualified Investor Scheme or an Undertaking for Collective Investments in Transferable Securities?

4.47 Instead of proposing a specific vehicle, many respondents from this group set out the characteristics they thought should be present. Typically, they recommended a structure that was cost effective and efficient, transparent and flexible. Direct ownership of assets was also preferred, as was a clear performance management system, so that a manager's contract could be terminated in the event of poor performance.

> We recognise that we are not experts in the legal and regulatory structure of CIVs... However we can comment on the characteristics that we would expect to see in such a CIV:
>
> - Appropriately regulated
> - Direct Ownership of Assets by investors
> - Tax efficiency and transparency
> - Segregation of liability at sub-fund level
> - Cost efficient
> - Flexible (broad range of asset classes and investment strategies)
> - Flexible (allow additional asset classes and strategies to be added)
>
> Cheshire Pension Fund

4.48 A small number of responses questioned whether the Government had the legal powers to create collective investment vehicles or require participation in them. Some also suggested that the procurement processes would also need to be carefully thought through depending on the legal ownership and creation of vehicle.

What governance arrangements should be established?

4.49 The role of the administering authority in a collective investment vehicle featured strongly in the consultation responses. Many argued that since the assets were owned by the local administering authorities, it was vital that they retained influence. Respondents were divided as to how this should be achieved, but most suggested some form of councillor involvement.

4.50 A popular proposal was to establish a joint committee of councillors to act as shareholders of the vehicle's operating company, drawing on the approach being taken by the London boroughs where the administering authorities each have an equal shareholding. However, others felt this would be unwieldy, with too many people involved in decision making and governance. They suggested that representative bodies of Chief Finance Officers, or the administering authorities' nominated councillors, select a few councillors to act on all of their behalf.

4.51 Some respondents also argued that Scheme members or independent professional advisors should play a role in the vehicle's governance structure. The model used by the National Employment Savings Trust (NEST) was put forward. It includes an elected body of trustees, a properly qualified executive team, and formal processes for engagement with members and employers. A few respondents also wanted greater delegation to professional managers to enable them to react to opportunities as they arose, for example, by allowing them to decide how an administering authority's investment portfolio is constructed.

> Such investment offices should be answerable to a governance board or panel representing the participating funds and their membership. Such boards may benefit from the presence of independent experts or advisers (the equivalent of independent trustees within a corporate trustee context).
>
> Insight Investment

4.52 There was an expectation amongst a few respondents that if collective investment vehicles were established, they would be public sector bodies, with in-house asset management where possible, drawing on skills already present within the Scheme. Some queried whether public sector pay constraints would make it difficult to retain good, skilled staff, while others pointed to the administering authorities that already have in-house investment teams.

4.53 A few respondents also questioned whether the collective investment vehicle should be profit making, with the profit returned to the pension funds. They argued that this would develop a culture of appropriate risk taking which would help the administering authorities to compete in markets against private sector organisations.

> Establishing a suitable level of fees is a further governance question. Is the CIV to be profit-making, and if so, should it be owned by the LGPS schemes so that any profit is returned to them? If not profit-making, will it be possible to develop an appropriate internal culture of risk-taking when competing in investment markets against private sector operators?
>
> Linchpin IFM

4.54 Finally, it was important to a few respondents that the structure made it possible for the administering authorities to fulfil their environmental, social and corporate governance commitments and strategies. For example, they argued that asset owners should be able to engage directly with the companies they are invested in and vote independently of fund managers, as set out in the UN Principles of Responsible Investment.

Government response

4.55 The Government has invited authorities to determine their own governance structures and approach to asset pools. In December 2014 PricewaterhouseCoopers were commissioned to analyse the different types of collective investment vehicle and legal structures available. To support authorities in the development of their asset pools, the Government has published this analysis, which is provided for information only. It does not represent the view of Government, and authorities should seek their own professional advice as necessary in the development of their asset pools.

4.56 The Government has included a separate criterion on governance to help authorities develop viable asset pools that streamline decision making while maintaining democratic accountability for the scheme. Authorities will need to design a governance structure that provides them with assurance that their investments are being managed appropriately by the pool and in line with their investment strategy, but also ensures that at the pool level, risk is adequately assessed and managed, a long-term view is taken, and a culture of continuous improvement adopted.

4.57 The Government agrees that authorities should act as responsible, long term investors within a pool and be able to give effect to their environmental, social and corporate governance policies. When developing their proposals for pooling, authorities will therefore need to determine how their individual investment policies will be reflected.

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?

4.58 There are two main types of investment approach, which can be used individually or in combination. Passive management typically invests assets to mirror a market in order to deliver a return comparable with the overall performance of the market being tracked. An actively managed fund employs a professional fund manager or investment research team to make discretionary investment decisions on its behalf. By using their expertise, it is hoped that active managers will deliver a level of return in excess of the market's performance, although this comes at a much higher cost than passive management and still has the risk of under performing the index.

4.59 Hymans Robertson considered the performance before fees of equities and bonds in aggregate across the Scheme over the 10 years to March 2013. This new analysis, evaluating the authorities' investments as one Scheme, showed that there was no clear evidence that the Scheme as a whole had outperformed the market in the long term. They concluded that listed assets such as bonds and equities could have been managed passively without affecting the Scheme's overall performance.

4.60 The consultation therefore advocated the use of passive management for bonds and equities, setting out four options for implementation which are discussed below. These ranged from making the proposals compulsory, to asking the administering authorities to consider the benefits of passive management in light of the evidence provided.

4.61 Just over three-quarters of respondents clearly stated a preference for one of the options. Almost all, around 97 per cent, favoured proposal three or four: using a "comply or explain" model or allowing administering authorities to evaluate and act on the evidence presented.

Option 1: Funds could be required to move all listed assets into passive management, in order to maximise the savings achieved by the Scheme.

4.62 Although no one suggested that passive management should be made compulsory, several respondents recognised that it had a role to play as part of a balanced portfolio. They saw passive management as a means of achieving greater transparency, lower transaction and governance costs, and reduced manager selection risk.

4.63 Some respondents went further, acknowledging that active management does not always achieve outperformance and so calling for a substantially passive approach. It was argued that this would free up resources to focus on governance and ensure that active managers were only used when the administering authority felt strongly that it would see consistent, positive returns.

4.64 However, none of the submissions voiced support for option one and a few asked whether the Government had the legal authority to require administering authorities to invest in a particular way. Many were concerned that the administering authorities would see lower returns, or called for the risks associated with passive management to be more closely examined. A summary of the issues raised is provided from paragraph 4.76 below.

Option 2: Alternatively, funds could be required to invest a specified percentage of their listed assets passively; or to progressively increase their passive investments.

4.65 Many of the respondents saw this as a variant of option one, as the administering authorities would still be required to invest a proportion of their assets in a particular way. As such, they argued that it was not viable for the same reasons that they felt passive management of listed assets should not be made compulsory.

4.66 A few felt that this option offered a balance between local control and the need to ensure a viable Scheme. They suggested that the level of passive management required could be individually negotiated, with better performing administering authorities given more autonomy and a higher percentage applied to those identified as poor performers.

4.67 Option two was also seen by a few respondents as a means to increase the use of passive management to a level that could allow it to be effectively managed through a collective investment vehicle. This would ensure that the scale needed for a pooled fund was achieved, while still allowing for some use of active management of listed assets.

Option 3: Fund authorities could be required to manage listed assets passively on a "comply or explain" basis.

4.68 The "comply or explain" approach was most popular with respondents, with around half of those who expressed a clear view preferring this option. It was suggested that a "comply or explain" framework might increase the use of passive management, while also improving the accountability and transparency of fund performance. Some felt that it would allow in-house management to continue, while others thought it could lead to better returns, as it may encourage administering authorities to use active management only where they felt strongly that it would add value.

4.69 However, respondents also argued that greater clarity was needed about how this option would work before reaching a conclusion. In particular, they wanted to ensure that the reporting mechanisms would not be too onerous, to understand what the administering authorities would be expected to "comply" with, and any consequences of non-compliance.

4.70 The 2009 Investment Regulations already require administering authorities to publish a Statement of Investment Principles which sets out the investment strategy adopted by that authority. Some respondents argued that the administering authorities already explain their investment approach through this Statement, while others thought that it could be expanded to meet the requirements of a "comply or explain" system.

4.71 A few responses suggested what the administering authorities might be required to "explain", such as the rationale for using active management; the reasons for any underperformance; and the governance processes in place, including the arrangements for the effective monitoring of fund managers. In addition, evidence to demonstrate the appropriate use of passive management and smarter benchmarks was also put forward.

4.72 Alternatively, a "perform or explain" framework was also proposed, focused on returns net of fees. Under this approach, administering authorities would be expected to demonstrate that they had considered the balance between the additional value secured and the fees being paid, when making their investments.

Option 4: 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.

4.73 Around a third of those who gave a clear view in response to this question felt that the administering authorities should be able to decide the extent to which they used passive management. They argued that since the administering authorities are best placed to formulate the investment strategy, they should also determine how it is implemented, including when to use active management. Indeed, some thought that this option would allow the administering authorities to ensure that the different reasons for making investments were properly reflected, for example to maximise capital growth, support cash-flow requirements or minimise volatility risk.

> ...funds increasingly want their managers to achieve a very fund-specific investment profile (return and risk), not just 'beat the index'. Examples include portfolios with a specific income bias, or risk strategy... or defined (constraints and discretions) set of investment opportunities. There are many examples of perfectly valid implementation styles which are not just about beating the index.
>
> Eric Lambert

4.74 However, some respondents argued that this option would simply maintain the current situation and so not go far enough. They argued that the administering authorities are already expected to consider the advantages of active and passive management when making their investments and the rationale for their approach should be set out in their investment strategy. Despite this, as the evidence in the Hymans Robertson report has shown, the administering authorities have been achieving an aggregate return equivalent to that of passive management, but paying for active. Furthermore, the report indicated that the Scheme as a whole was using less passive management than peer group of large pension funds in the CEM analysis.[3]

Other options to be considered

4.75 Finally, a few responses suggested alternative ways to implement the proposals:

- Administering authorities could be required by law to account transparently for all investment fees, including those paid through management contracts, unitised investment vehicles, or to consultants. This could include an explanation of the value added in comparison to that available from the use of in-house management teams.

[3] Department for Communities and Local Government: Local Government Pension Scheme structure analysis, Hymans Robertson p.14
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/307926/Hymans_Robertson_report.pdf

- A cap on active management fees or an overall budget for investment management could be set out, in order to drive down fees and encourage administering authorities only to use active management where they were most confident of securing higher returns.
- The impact of collective investment vehicles on performance could be evaluated before deciding whether to make passive management of listed assets compulsory. It was argued that administering authorities may gain access to better governance and fund managers through the vehicle, helping poorer performing administering authorities to improve so that the Scheme would achieve an aggregate investment return above the passive benchmark. A few responses went further, suggesting that the London collective investment vehicle could be used as a pilot to test the impact of pooling investments on performance.

Passive management should not be made compulsory

4.76 As indicated in paragraph 4.64, while some of the respondents recognised the benefits of passive management, none voiced support for making it compulsory. This section attempts to capture the main reasons put forward for the continued use of some active management, which many felt was important for a balanced investment portfolio.

<u>A role for active management</u>

4.77 Respondents from both the public and private sectors sought to demonstrate how the administering authorities had benefited from active management, citing examples of investments that had delivered a return above the benchmark set. Many were concerned that these higher returns, which they felt might outweigh the potential cost savings, would be lost if the administering authorities were required to move to passive management of bonds and equities.

> A comparison of lost performance vs. reduced investment fees over this period shows that a total passive approach might reduce this annual cost by £20m over 10 years but this has to be offset against our investment outperformance. Over the last 10 years the Fund has achieved +0.5% returns per annum above the benchmark. Given the average value of the Fund during that period our active approach has added at least £75m to the value of the Fund which more than covers the extra active management costs (£20m) over the same period.
>
> Greater Gwent Pension Fund

4.78 Another popular argument was that the reforms should just apply to the poorer performing administering authorities. Those able to evidence the effective use of active management would not be required to invest passively in bonds and equities. It was suggested that this would bring up the overall performance of the Scheme, without penalising those achieving higher returns. It was less clear how the better performing administering authorities would be identified, although there was a broad consensus that evidence of strong governance and performance to date should be considered.

Of the actively managed equity portfolios, global equity represented by far the greatest proportion of actively managed assets [in London]. Our analysis found that for 2012/13 that in aggregate London Funds would have been £49.4 Million better off had they invested passively – however there were a significant number of funds who were worse off. If only those getting returns lower than the passive benchmark were able to achieve passive returns and those that got superior returns were able to keep those excess returns then London funds would have been £101.3 Million better off.

Society of London Treasurers

4.79 Similarly, some respondents felt that there were some asset classes where active management may add more value, or where passive management might not be suitable. These included less efficient markets such as the emerging markets, more complex asset classes like private equity, and investment strategies that are difficult to replicate using an index, such as a return in excess of a benchmark like LIBOR.[4]

4.80 Most commonly, however, respondents thought that corporate bonds should be managed actively. Some suggested that it was difficult to replicate a corporate bond index passively, so high tracking errors would arise reducing the returns available. Others stressed that because corporate bond indices are based on the value of debt issued, the investors largest holdings would be with the organisations with the most debt. They argued that this increased the chance of a default and investment losses.

4.81 Finally, some suggested the rules of the market and some indices would mean that investment opportunities might missed; for example if the value of the bond was below the threshold for inclusion in most indices. It was also thought that losses would be incurred that could be avoided by active investors:

Standard credit indices have strict rules regarding the credit ratings of the underlying constituent securities to reflect different levels of credit risk. In particular, investment grade indices stipulate that only bonds rated at or above BBB -/Ba
the indices. This means that, should an issuer be downgraded to being rated below investment lg be forced out of the index at the end of the month of downgrade, forcing index -track
distressed prices. Such "fallen angels," however, often bounce back; losses initially experienced upon, or in the lead -u
partially recouped in the following months. For the passive investor the initial losses are locked in as the bond falls out of the index and subsequent gains are not captured.

Western Asset Management Company Limited

Risks and issues of passive management

4.82 Some respondents were concerned that compulsory passive management might increase the administering authorities' exposure to risk. For example, they argued that passive managers are unable to react to changes in the market, or mitigate risks by selecting investments based on value rather than market position. Others argued that

[4] LIBOR is the London Interbank Offered Rate. This is the average interest rate estimated by lending banks in London that the average lending bank would be charged if borrowing from other banks.

since passive funds usually follow the relative value of investments in an index, investments can become concentrated or over-exposed to individual companies.

> When investors buy the S&P 500 [Standard and Poor's] they are expecting allocation to 500 names. In fact, the top 50 weightings (or 10% of the names) make up almost 50% of the index by market cap – there is more stock specific risk than many might expect.
>
> Unigestion (UK) Limited

4.83 The risk that passive management may lead to lower returns or higher costs than expected was also raised. Most passive funds track the index based on market capital weight, the relative values of the organisations within the index. Some respondents argued that since this market capital weighted approach always follows the movements of the markets, passive funds tend to buy shares when they are getting more expensive and sell them as they are losing value. In addition, it was suggested that active managers might be able to exploit the fact that a higher proportion of the market will be passively invested, since its behaviour will be predictable. As such, active managers may be able to increase their profits at the expense of the Scheme.

Environmental, Social and Corporate Governance Policies

4.84 Respondents from the public, private and civil society sectors all highlighted the importance of ensuring that administering authorities could still implement their environmental, social and corporate governance policies. This was thought to be particularly important where an administering authority had signed up to the UN Principles of Responsible Investment. Some responses felt that a passive management approach would prevent the administering authorities from carrying out these policies. For example, an index tracking passive fund could include an organisation that did not meet their environmental standards. Others referenced the Professor Kay Review into the UK Equity Market and Long Term Decision Making,[5] suggesting that the benefits of good stewardship advocated by Professor Kay, such as playing an active role as a shareholder, could be lost if passive management was used.

Government response

4.85 The Government has considered the responses received and arguments put forward surrounding the use of passive management. Recognising the different needs of each authority, the Government has invited authorities to develop their own proposals to pool their assets. In so doing, authorities will need to address the criterion of reduced costs and excellent value for money. This places the emphasis on authorities to transparently assess their investment costs and fees, and to set out the savings they can deliver over the long term as a result of pooling.

4.86 The Government recognises that both active and passive management have a role to play in the Local Government Pension Scheme. However, authorities should only use active fund management where it can be shown to deliver value for money, and authorities should review how fees and net performance in each listed asset class compare to a

[5] https://www.gov.uk/government/consultations/the-kay-review-of-uk-equity-markets-and-long-term-decision-making

passive index. In addition, authorities should consider setting targets for active managers which are focused on achieving risk-adjusted returns over an appropriate long term time period, rather than solely focusing on short term performance comparisons.

Alternative proposals for reform, and deficit reduction in particular

4.87 The consultation also asked respondents to put forward their proposals for reducing deficits. Some respondents took the opportunity to stress that the deficits had arisen for a number of complex and varied reasons, such as contribution holidays, low gilt yields and increasing longevity. Others offered alternative governance, investment and administration reforms, intended to improve performance or address deficits.

Improving governance and reporting

4.88 Some respondents felt that improving decision making and governance would lead to higher returns and so help to reduce the deficits. It was argued that decision making would improve with the publication of more data and performance reports, such as:

- Implementing and reporting against the Myners Principles;[6]
- Improving the information provided to beneficiaries, so that they can better understand where the assets are being invested;
- Introducing regulations to require the setting, monitoring and reporting of progress against agreed governance objectives.

4.89 A few submissions also called for greater professionalization of the management of the Scheme, wanting more in-house expertise able to develop and implement investment strategies.

4.90 Alternatively, a small number of respondents advocated an employer focused approach. They proposed establishing administering authorities for larger groups of employers, such as academies or higher education institutes, which may have a common deficit and cash-flow profile. This was thought to offer these employers a greater role in the governance of the Scheme and an investment strategy that better met their circumstances and so was more likely to drive down their proportion of the existing deficit.

Long term focus

4.91 However, some respondents were concerned that a focus on deficit reduction may lead to a short-term view of performance and lower returns. They argued that administering authorities should adopt a longer-term approach, for example reviewing performance annually rather than quarterly, as recommended by Professor Kay in his Review of UK Equity markets and Long-term Decision-making. It was thought that a longer term approach would lead to high investment returns and therefore reduce the deficit.

[6] http://www.thepensionsregulator.gov.uk/docs/igg-myners-principles-update.pdf

> It is still the case that a large majority of funds will hold their asset managers to account for quarterly performance, driving short-term behaviour. Hymans Robertson identify the retention of managers for the long-term, "even through inevitable periods of underperformance", as a key characteristic of the top ten performing funds they looked at. We believe performance and fees should be structured over time-frames that are measures in multiple years, rather than quarters.
>
> Sarasin & Partners LLP

Government response

4.92 The Government agrees that authorities should take a long-term view of their investments. The consultation on revoking and replacing the existing Investment Regulations 2009 proposes to remove the requirement to review managers' performance quarterly, encouraging a longer-term view. The criteria for reform also make clear that authorities will wish to consider the findings of the Kay Review when developing their proposals, including what governance procedures and mechanisms would be needed to facilitate long term responsible investing and stewardship through a pool.

Annex A: List of respondents

330 Consulting Limited
Adams Street Partners
AGF International Advisers Co. Ltd
AllenbridgeEpic Investment Advisers Limited
AllianceBernstein Limited
Allianz Global Investors
Angela Pober
Aon Hewitt
AquilaHeywood
Association of Investment Companies
Association of Pension Lawyers
Association of Real Estate Funds
Association of School and College Leaders
Aviva Investors
Avon Pension Fund
AXA Investment Managers
Baillie Gifford & Co
Baring Asset Management
London Borough of Barking and Dagenham
Barnett Waddingham LLP
Barry Town Council
Bedfordshire Pension Fund
London Borough of Bexley Pension Fund
Bfinance UK Limited
BlackRock
BNY Mellon
Brent Pension Fund
British Private Equity and Venture Capital Association
British Property Federation and Investment Property Forum
London Borough of Bromley
Buckinghamshire County Council Pension Fund
Cambridgeshire Pension Fund
London Borough of Camden Pension Fund
Capital Dynamics
Capital Group
Cardiff and Vale of Glamorgan Pension Fund
Carmarthenshire County Council
CBRE Capital Advisors Limited
CBRE Global Investors
CFA Society of the UK
Charles Stanley Pan Asset Capital Management Limited
Cheshire Pension Fund
Chris Bilsland
Chartered Institute of Public Finance and Accountancy (CIPFA)
City and Council of Swansea Pension Fund

City of London Corporation
Clerus
Clwyd Pension Fund
Cornwall Pension Fund
Councillor John Fuller
London Borough of Croydon
Cumbria Pension Fund
Debra Hopkins
Deloitte
Derbyshire County Council Pension Fund
Devon County Council Pension Fund
Devon County UNISON
Dorset County Pension Fund
Durham County Council Pension Fund
London Borough of Ealing
East of England LGA
East Riding Pension Fund
East Sussex Pension Fund
London Borough of Enfield
Environment Agency
Eric Lambert
Essex Pension Fund
F&C Investment Business Ltd (Private Equity Funds)
F&C Investment Business Ltd (Sales and Client Relationships)
Fidelity Worldwide Investment
First State Investments
Fred Green
Generation Investment Management LLP
Gloucestershire Pension Fund
GMB
Greater Gwent Pension Fund
Greater Manchester Pension Fund
Gwynedd Pension Fund
London Borough of Hackney
Hampshire County Council
HarbourVest Partners UK Limited
London Borough of Haringey Pension Fund
Henderson Global Investors
Hermes Fund Managers
Hertfordshire County Council
London Borough of Hounslow
Hymans Robertson LLP
Insight Investment
Invesco Perpetual
Investec Asset Management
Investment Management Association
Islington Pension Fund
JLT Employee Benefits
John Raisin Financial Services Limited

Joint response from civil society organisations
Jupiter Asset Management Limited
Kent County Council Pension Fund
London Borough of Lambeth
Lancashire County Pension Fund
Lazard Asset Management - UK
Legal and General Investment Management
Leicestershire County Council Pension Fund
Leslie Robb
Linchpin IFM, now providing advisory services as City Noble Limited
Lincolnshire Pension Fund
Local Government Association
Lombard Odier Asset Management (Europe) Limited
London Councils
London Pension Fund Authority
Longview Partners
Loomis Sayles Investments Limited
M&G Investments
Majedie Asset Management Ltd
Manchester City Council
Mark Solomon
Markham Rae LLP
Mercer Limited
Merseyside Pension Fund
London Borough of Merton
MFS International (UK) Limited
Milton Keynes Council
MSCI
National Association of Pension Funds
National Housing Federation
National LGPS Frameworks
Natixis Global Asset Management (UK) Limited
Neuberger Berman
London Borough of Newham
Newton Investment Management Limited
Nomura Asset Management UK Limited
Norfolk Pension Fund
North Yorkshire Pension Fund
Northamptonshire Pension Fund
Northern Trust
Northumberland County Council Pension Fund
Nottinghamshire Pension Fund
Osborne Clarke
Oxfordshire Pension Fund
Pantheon Ventures (UK) LLP
Partners Group (UK) Limited
Peter Moon
Pictet Asset Management
PIMCO

PricewaterhouseCoopers LLP
Principles for Responsible Investment
Pyrford International Limited
London Borough of Redbridge
Rhondda Cynon Taff Pension Fund
London Borough of Richmond Upon Thames
Rogge Global Partners
Royal Borough of Greenwich Pension Fund
Royal Borough of Kingston Upon Thames Pension Fund
Royal Borough of Windsor and Maidenhead
Royal London Asset Management
Ruffer LLP
Russell Investments
Sarasin & Partners LLP
Schroders
Shadow Scheme Advisory Board
Shropshire County Pension Fund
SKAGEN Funds
Society of County Treasurers
Society of London Treasurers
Society of Pension Consultants
Society of Welsh Treasurers
Somerset County Council Pension Fund
South Yorkshire Pensions Authority
Squire Patton Boggs (UK) LLP
Staffordshire Pension Fund
Stamford Associates Limited
Standard Life Investments
State Street Global Services
Steve Bloundele
Suffolk Pension Fund
Surrey Pension Fund
London Borough of Sutton
Tameside Council
Teesside Pension Fund
Threadneedle Investments
Torfaen County Borough Council
London Borough of Tower Hamlets
Towers Watson
Tri-Borough pension funds (City of Westminster; London Borough of Hammersmith and Fulham; and the Royal Borough of Kensington and Chelsea)
Tyne and Wear Pension Fund
UBS Global Asset Management
UK Sustainable Investment and Finance Association
Unigestion (UK) Limited
UNISON
Unite
Universities & Colleges Employers Association (UCEA)
Vale of Glamorgan Council

London Borough of Waltham Forest
Wandsworth Council
Warwickshire Pension Fund
West Midlands Integrated Passenger Transport Authority
West Midlands Pension Fund
West Sussex County Council Pension Fund
West Yorkshire Pension Fund
Western Asset Management Company Limited
Wiltshire Pension Fund
Worcestershire County Council

3

Department for
Communities and
Local Government

Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009

Consultation

November 2015
Department for Communities and Local Government

This document/publication is also available on our website at www.gov.uk/dclg

If you have any enquiries regarding this document/publication, complete the form at http://forms.communities.gov.uk/ or write to us at:

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2 Marsham Street
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November 2015

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About this consultation

This consultation document and consultation process have been planned to adhere to the Consultation Principles issued by the Cabinet Office.

Representative groups are asked to give a summary of the people and organisations they represent, and where relevant who else they have consulted in reaching their conclusions when they respond.

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

The Department for Communities and Local Government will process your personal data in accordance with DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

Individual responses will not be acknowledged unless specifically requested.

Your opinions are valuable to us. Thank you for taking the time to read this document and respond.

Are you satisfied that this consultation has followed the Consultation Principles? If not or you have any other observations about how we can improve the process please contact DCLG Consultation Co-ordinator.

Department for Communities and Local Government

2 Marsham Street

London

SW1P 4DF

or by e-mail to: consultationcoordinator@communities.gsi.gov.uk

The consultation process and how to respond

Scope of the consultation

Topic of this consultation:	This consultation proposes to revoke and replace the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 with the draft regulations described in this paper. There are two main areas of reform: 1. A package of reforms that propose to remove some of the existing prescribed means of securing a diversified investment strategy and instead place the onus on authorities to determine the balance of their investments and take account of risk. 2. The introduction of safeguards to ensure that the more flexible legislation proposed is used appropriately and that the guidance on pooling assets is adhered to. This includes a suggested power to allow the Secretary of State to intervene in the investment function of an administering authority when necessary.
Scope of this consultation:	Views are sought on: 1. Whether the proposed revisions to the investment regulations will give authorities the flexibility to determine a suitable investment strategy that appropriately takes account of risk. 2. Whether the proposals to introduce the power of intervention as a safeguard will enable the Secretary of State to intervene, when appropriate, to ensure that authorities take advantage of the benefits of scale offered by pooling and deliver investment strategies that adhere to regulation and guidance.
Geographical scope:	This consultation applies to England and Wales.
Impact Assessment:	The proposed interventions affect the investment of assets by local government pension scheme administering authorities. These authorities are all public sector organisations, so no impact assessment is required.

Basic Information

To:	The consultation is aimed at all parties with an interest in the Local Government Pension Scheme (the Scheme) and in particular those listed on the Government's website: https://www.gov.uk/government/publications/local-government-pension-scheme-regulations-information-on-who-should-be-consulted
Body/bodies responsible for the consultation:	Secretary of State, Department for Communities and Local Government. The consultation will be administered by the Workforce, Pay and Pensions Division.
Duration:	25 November 2015 to 19 February 2016
Enquiries:	Enquires should be sent to Victoria Edwards. Please email LGPSReform@communities.gsi.gov.uk or call 0303 444 4057.
How to respond:	Responses to this consultation should be submitted to LGPSReform@communities.gsi.gov.uk by **19 February 2016**. Electronic responses are preferred. However, you can also write to: LGPS Reform Department for Communities and Local Government 2/SE Quarter, Fry Building 2 Marsham Street London SW1P 4DF
Additional ways to become involved:	If you would like to discuss the proposals, please email LGPSReform@communities.gsi.gov.uk
After the consultation:	All consultation responses will be reviewed and analysed. A Government response will then be published within three months, and subject to the outcome of this consultation, the resulting regulations laid in Parliament.
Compatibility with the Consultation Principles:	This consultation has been drafted in accordance with the Consultation Principles.

Background

Getting to this stage:	The proposals in this consultation are the culmination of work looking into Local Government Pension Scheme investments that began in early 2013. It has been developed in response to the May 2014 consultation, *Opportunities for collaboration, cost savings and efficiencies,* which considered whether savings might be delivered through collective investment and greater use of passive fund management. A copy of the consultation and the Government's response is available on the Government's website: https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies. The consultation responses called for a voluntary approach to reform, opposing the introduction of a single, national model of pooling. The Government has therefore invited authorities to develop their own proposals for pooling, subject to common criteria and guidance. The criteria for reform have been developed using the consultation responses and following a series of workshops and conversations with authorities and the fund management industry since the July Budget 2015. Some respondents to the May 2014 consultation also suggested that amendments were required to the investment regulations in order to facilitate greater investment in pooled vehicles. In addition, prior to that consultation, authorities and the fund management industry had called for wider reform. A small working group, whose participants are listed in Annex A, was established to look at whether the approach to risk management and diversification in the existing regulations was still appropriate. They recommended moving towards the "prudential person" approach that governs trust based pension schemes. The group also sought clarity as to whether certain types of investment were possible, such as the use of derivatives in risk management. The work of that group has informed the development of this consultation. In relaxing the regulatory framework for scheme investments, it is important to introduce safeguards to ensure that the less prescriptive approach is used appropriately. The July Budget 2015 announcement also indicated that measures should be introduced to ensure that those authorities who do not bring forward ambitious proposals for pooling, in keeping with the criteria, should be required to pool. This consultation therefore sets out how the Secretary of State might intervene to ensure that authorities take advantage of the benefits of scale offered by pooling and deliver investment strategies that adhere to regulation and guidance.

Previous engagement:	The proposed changes in this consultation are the result of a programme of engagement that began in summer 2013: • Round table event, 16 May 2013. Representatives of administering authorities, employers, trade unions, the actuarial profession and academia discussed the potential for increased cooperation within the Scheme. • A call for evidence, run with the Local Government Association, June to September 2013. This gave anyone with an interest in the Scheme the opportunity to inform the Government's thinking on potential structural reform. The results were shared with the Shadow Scheme Advisory Board, which provided the Minister for Local Government with their analysis of the responses. • Consultation, *Opportunities for collaboration, cost savings and efficiencies,* May to June 2014. The consultation set out how savings of £470-660m a year could be achieved by collective investment and greater use of passive fund management. It also sought views as to how these reforms might best be implemented. The Government's response is available online: https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies. • Informal engagement, July to November, 2015. Since the July Budget 2015 announcement, officials have attended over 25 workshops and bi-lateral meetings with administering authorities and the fund management industry. These discussions have been used to develop the criteria for reform and inform how the proposed power of the Secretary of State to intervene might work. In addition, the Investment Regulation Review Group was formed in 2012 to consider potential amendments to the investment regulations. The group included representatives from administering authorities, actuarial firms, pension lawyers and the fund management industry. An initial proposal for reform was prepared that has also informed the development of the draft regulations that are the subject of this consultation.

Introduction and Background

Introduction

1.1 In May 2014 the Government published a consultation which set out how savings of up to £660m a year might be achieved through greater use of passive management and pooled investment. Investing collectively can help authorities to drive down costs and access the benefits of scale, and also enables them to develop the capacity and capability to invest more cost effectively in illiquid asset classes such as infrastructure. The Government has therefore invited authorities to develop ambitious proposals for pooling assets that meet published criteria. More information about the criteria and process of reform is available on the Government's website: https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance.

1.2 This consultation complements that invitation, recognising that the existing regulations place restrictions on certain investments that may constrain authorities considering how best to pool their assets. It therefore proposes to move to a prudential approach to securing a diversified investment strategy that appropriately takes account of risk. In so doing, and to ensure that authorities take advantage of the benefits of scale, the Government proposes to introduce a power to allow the Secretary of State to intervene to ensure that authorities take advantage of the benefits of scale offered by pooling and deliver investment strategies that adhere to regulation and guidance.

1.3 This paper sets out the purpose and rationale of the suggested amendments to the investment regulations, and seeks views as to whether the proposed approach would best deliver those stated aims.

Background

1.4 With assets of £178bn at its last valuation on 31 March 2013, the Local Government Pension Scheme is one of the largest funded pension schemes in Europe. Several thousand employers participate in the Scheme, which has a total of 4.68 million active, deferred and pensioner members.[1] The Department for Communities and Local Government is responsible for the regulatory framework governing the Scheme in England and Wales.

1.5 The Scheme is managed through 90 administering authorities which broadly correspond to the county councils following the 1974 local government reorganisation as well as each of the 33 London boroughs. In most cases, the administering authorities are upper tier local authorities such as county or unitary councils, but there are also some authorities established specifically to manage their pension liabilities, for example the London Pension Fund Authority and the Environment Agency Pension Fund. The

[1] Scheme asset value and membership figures taken from Department for Communities and Local Government statistical data set - Local government pension scheme funds summary data: 2012 to 2013 https://www.gov.uk/government/statistical-data-sets/local-government-pension-scheme-funds-summary-data-2012-to-2013

administering authorities have individual governance and working arrangements. Each has its own funding level, cash-flow and balance of active, deferred and pensioner members. Authorities take these circumstances into account when preparing their investment strategies, which are normally agreed by the councillors on each authority's pension committee. The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 set the legal framework for the development of these investment strategies and the investments carried out by administering authorities. This consultation proposes that the Government revokes and replaces those regulations.

1.6 Under the Public Service Pensions Act 2013, there is a requirement for a national scheme advisory board, as well as a local board for each of the 90 funds. In 2013, Scheme employers and the trade unions established a shadow board, which has been considering a number of issues connected with the Scheme, including its efficient management and administration. Appointments have now been made to the national scheme advisory board and the Chair is expected to be appointed shortly.

Getting to this stage

2.1 The consultation is formed of two main proposals:

1. A package of reforms that propose to remove some the existing prescribed means of securing a diversified investment strategy and instead place the onus on authorities to determine the balance of their investments and take account of risk. The changes proposed would move towards the "prudent person" approach to investment that applies to trust based pension schemes.
2. The introduction of safeguards to ensure that the more flexible legislation proposed is used appropriately, and that the guidance on pooling assets is adhered to, including a power to allow the Secretary of State to intervene in the investment function of an administering authority when necessary.

Pooling assets to deliver the benefits of scale

2.2 The proposals set out in this consultation are the culmination of work carried out over the last two and a half years to explore how to reform the way the Scheme makes its investments in order to achieve the benefits of scale and drive efficiencies.

2.3 In summer 2013, the coalition government launched a call for evidence to explore how the Scheme might be made more sustainable and affordable in the long term. 133 responses were received, many of which took the opportunity to discuss whether collective investment and greater collaboration might deliver savings for the Scheme.

2.4 Following the call for evidence, the Minister for the Cabinet Office and Minister for Local Government commissioned a cost-benefits analysis from Hymans Robertson on a range of proposals. Hymans Robertson's report explored three areas:

- **The cost of investment:** Many of the costs associated with investment are not transparent and so difficult to capture. The costs of managing and administering the Scheme were reported as being £536 million in 2012-13.[2] However, Hymans Robertson found that the actual cost was likely to be rather higher; with investment costs alone estimated as in excess of £790 million a year.[3]
- **Approaches to collaboration:** Hymans Robertson was asked to examine the costs and benefits of three options for reform: merging the authorities into 5-10 funds, creating 5-10 collective investment vehicles, or establishing just 1-2 collective investment vehicles. They found that the net present value of savings over ten years was highest with a small number of vehicles, while merging funds offered the lowest benefit.[4]

[2] Local government pension scheme funds summary data: 2012 to 2013
[3] Department for Communities and Local Government: Local Government Pension Scheme structure analysis, Hymans Robertson pp. 10-11. https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies
[4] Hymans Robertson, p.6

- **The aggregate performance of the scheme:** The report found that the Scheme as a whole had been achieving the market rate of return in each of the main equity markets over the ten years to March 2013. If the Scheme's investments in bonds and equities had been managed passively instead of actively, authorities could have saved at least £230m a year in management fees without affecting overall investment returns.[5]

2.5 Drawing on the Hymans Robertson report and the call for evidence, the coalition government published a consultation in May 2014 entitled *Opportunities for collaboration, cost savings and efficiencies*. This set out how the Scheme could save up to £660m a year by using collective investment vehicles and making greater use of passive management for listed assets like bonds and equities. The consultation sought views on these proposals, and how they might be most effectively implemented. Respondents were broadly in favour of pooling assets, but felt that any reform should be voluntary and led by administering authorities. While many recognised a role for passive management in an investment strategy, most also felt that some active management should be retained.

2.6 At the July Budget 2015, Ministers having reflected on the consultation responses, the Chancellor announced the Government's intention to invite administering authorities to bring forward proposals for pooling local government pension scheme investments. Authorities' proposals would be assessed against published criteria, designed to encourage ambition in the pursuit of efficiencies and the benefits of scale. These criteria have now been published and are available online at https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance.

Updating the investment regulations

2.7 When considering the implications of creating asset pools amongst authorities, some respondents to the May 2014 consultation took the opportunity to call for a review of the existing investment regulations. At their introduction in 2009, the regulations sought to ensure that authorities established a balanced and diversified portfolio by placing restrictions on the proportion of their assets that could be invested in different vehicles. For example, deposits with a single bank, institution or person, (other than the National Savings Bank), were restricted to 10% of an authority's assets. These restrictions have been kept under regular review and have been subject to change following representations from the investment sector and pension fund authorities.

2.8 Some respondents to the consultation suggested that the current limits on investments would prevent authorities from making meaningful allocations to a collective investment vehicle, one of the leading options for asset pooling, as the allocation to particular types of vehicle is capped at 35%. Participants in the London Boroughs' collective investment vehicle and the collaboration between the London Pension Fund Authority and Lancashire County Council also wrote to the Department encouraging reform in this area.

[5] Hymans Robertson, p.12

2.9 While the proposals for collective investment in the May 2014 consultation prompted encouragement to review the investment regulations, the idea of reform was not new. In 2012, following representations from the investment sector, the Government formed a small working group to revisit and examine the investment regulations with input from actuaries, fund managers and administering authorities. This group, whose membership is set out in Annex A, recommended that a more permissive approach should be taken to the legislative framework, similar to the "prudent person" model that applies to trust based pension schemes. This approach places the onus on the pension fund to determine a suitable balance of investments to meet its liabilities, which are clearly articulated in an investment strategy. The group also felt that the existing regulations introduced uncertainty for some authorities as to what constituted a permitted investment, as some asset classes were explicitly referenced but others were not. In particular, concern has been expressed as to whether or not pension fund authorities are permitted to invest in vehicles such as derivatives, hedge funds and forward currency contracts.

2.10 The proposals in this consultation paper therefore seek to address these issues, placing the onus on authorities to determine a diversified investment strategy that appropriately takes risk into account.

2.11 However, in relaxing the regulatory framework for scheme investments, it is also important to introduce safeguards to ensure that the less prescriptive approach proposed is used appropriately. Similarly, the July Budget 2015 announcement stated that draft regulations would be introduced to require an authority to pool its investments if it did not bring forward ambitious proposals that met the Government's criteria. This consultation therefore sets out how the Secretary of State might intervene to ensure that authorities take advantage of the benefits of scale offered by pooling and deliver investment strategies that adhere to regulation and guidance.

Response to the Law Commission's Review of Fiduciary Duty

2.12 The Kay Review on Fiduciary Duty published its final report in July 2012. In addition to making a number of recommendations to address the excessive focus on short-term performance in equity investment markets, it recommended that the Government ask the Law Commission to review the fiduciary duties of investment intermediaries amid concerns that these common law duties were being interpreted by some pension schemes as a requirement to focus solely on short-term financial returns.

2.13 In their report, published in July 2014, the Law Commission called on the Department to review:

- Whether the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 should transpose article 18(1) of the Institutions for Occupational Retirement Provision (IORP) Directive, and
- Those aspects of Regulation 9 of the 2009 Regulations which require investment managers to be appointed on a short-term basis and reviewed every three months.

2.14 These recommendations were supported by the Government's progress report on the implementation of the Kay Review published in October 2014 by the Department for Business Innovation and Skills.

2.15 Article 18(1) of the IORP Directive requires assets to be invested in the best interests of members and beneficiaries and, in the event of a conflict of interest, in the sole interests of members and beneficiaries.

2.16 Regulation 4 of The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005 No 3378) transposed Article 18(1):

"4. (1) The trustees of a trust scheme must exercise their powers of investment, and any fund manager to whom any discretion has been delegated under section 34 of the 1995 Act (power of investment and delegation) must exercise the discretion, in accordance with the following provisions of this regulation

(2) The assets must be invested:

(a) In the best interests of members and beneficiaries; and

(b) In the case of a potential conflict of interest, in the sole interest of members and beneficiaries."

2.17 The Local Government Pension Scheme is a statutory scheme made under section 1 of the Public Service Pensions Act 2013 and previously under The Superannuation Act 1972. It is not subject to trust law and those responsible for making investment decisions in the Scheme are not therefore required to comply with Regulation 4 of the 2005 Regulations.

2.18 However, this does nothing to change the general legal principles governing the administration of Scheme investments and how those responsible for such decisions should exercise their duties and powers under the Scheme's investment regulations.

2.19 In a circular issued by the then Department of the Environment in 1983 (No 24), the Secretary of State took the view that administering authorities should pay due regard to the principle contained in the case of Roberts v Hopwood [1925] A.C. 578 p. 595:

"A body charged with the administration for definite purposes of funds contributed in whole or in part by persons other than members of that body owes, in my view, a duty to those latter persons to conduct that administration in a fairly business-like manner with reasonable care, skill and caution, and with a due and alert regard to the interest of those contributors who are not members of the body. Towards these latter persons, the body stands somewhat in the position of trustees or managers of the property of others."

2.20 Those in local government responsible for making investment decisions must also act in accordance with ordinary public law principles, in particular, the ordinary public law principles of reasonableness. They risk challenge if a decision they make is so unreasonable that no reasonable person acting reasonably could have made it.

2.21 Having considered fully the recommendation made by the Kay Review and supported by both the Law Commission and the Government, Ministers are satisfied that the Scheme is consistent with the national legislative framework governing the duties placed on those responsible for making investment decisions. The position at common law is also indistinguishable from that produced by the 2005 Regulations applicable in respect of trust-based schemes.

2.22 We do, however, propose to remove the requirement for the performance of investment managers to be reviewed once every three months from the regulations.

Proposal 1: Adopting a local approach to investment

Deregulating and adopting a local approach to investment

3.1 In developing these draft regulations, the Government has sought, where appropriate, to deregulate and simplify the regulations that have governed the management and investment of funds since 2009. Some of the existing provisions have not been carried forward into the draft 2016 Regulations in the expectation that they would be effectively maintained by general law provisions and so specific regulation is no longer needed. For example, those making investment decisions are still required to act prudently, and there remains a statutory requirement to take and act on proper advice. Some of the provisions in the 2009 Regulations which have not been carried forward on this basis include:

- Stock lending arrangements under Regulation 3(8) and (9) of the 2009 regulations. The view is taken that the definition of "investment" in draft Regulation 3 is sufficient given that a stock lending arrangement can only be used if it falls within the ordinary meaning of an "investment".
- Regulation 8(5) of the 2009 regulations ensures that funds are managed by an adequate number of investment managers and that, where there is more than one investment manager, the value of the fund money managed by them is not disproportionate. Here, the view is taken that administering authorities should be responsible for managing their own affairs and making decisions of this kind based on prudent and proper advice.
- There are many provisions in the 2009 Regulations which impose conditions on the choice and terms of appointments of investment managers. Since the activities of investment managers are governed by the contracts under which they are appointed, the view is taken that making similar provision in the 2016 Regulations would be unnecessary duplication. Examples include the requirement for investment managers to comply with an administering authority's instructions and the power to terminate the appointment by not more than one month's notice.
- Regulation 12(3) of the 2009 Regulations requires administering authorities to state the extent to which they comply with guidance given by the Secretary of State on the Myners principles for investment decision making. As part of the wider deregulation, the draft regulations make no provision to report against these principles, although authorities should still have regard to the guidance.

3.2 These examples of deregulation are for illustrative purposes only. It is not an exhaustive list of provisions which the Government proposes to remove. Consultees are asked to look carefully at the full extent of deregulation and comment on any particular case that raises concerns about the impact such an omission might have on the effective management and investment of funds.

Investment strategy statement

3.3 As part of this deregulation, the draft regulations also propose to remove the existing schedule of limitations on investments. Instead authorities will be expected to take a prudential approach, demonstrating that they have given consideration to the suitability of different types of investment, have ensured an appropriately diverse portfolio of assets and have ensured an appropriate approach to managing risk.

3.4 Key to this will be the investment strategy statement, which authorities will be required to prepare, having taken proper advice, and publish. The statement must cover:

- A requirement to use a wide variety of investments.
- The authority's assessment of the suitability of particular investments and types of investments.
- The authority's approach to risk, including how it will be measured and managed.
- The authority's approach to collaborative investment, including the use of collective investment vehicles and shared services.
- The authority's environmental, social and corporate governance policy.
- The authority's policy on the exercise of rights, including voting rights, attached to its investments.

Transitional arrangements

3.5 Draft regulation seven proposes to require authorities to publish an investment strategy statement no later than six months after the regulations come into force (this is currently drafted as 1 October 2016, in case the draft regulations come into effect on 1 April 2016). However, the draft regulations would also revoke the existing 2009 Regulations when they come into effect. Transitional arrangements are therefore required to ensure that an authority's investments and investment strategy are regulated between the draft regulations coming into effect and the publication of an authority's new investment strategy statement. The transitional arrangements proposed in draft regulation 12 would mean that the following regulations in the 2009 Regulations would remain in place until the authority publishes an investment strategy or six months lapses from the date that the regulations come into effect:

- 11 (investment policy and investment of pension fund money)
- 14 (restrictions on investments)
- 15 (requirements for increased limits)
- Schedule 1 (table of limits on investments)

Statement of Investment Principles

3.6 We do not propose to carry forward the existing requirement under regulation 12 of the 2009 Regulations to maintain a Statement of Investment Principles. However, the main elements, such as risk, diversification, corporate governance and suitability, will instead be carried forward as part of the reporting requirements of the new investment strategy statement. Administering authorities will still be required to maintain their funding strategy statements under Regulation 58 of the 2013 regulations.

Non-financial factors

3.7 The Secretary of State has made clear that using pensions and procurement policies to pursue boycotts, divestments and sanctions against foreign nations and the UK defence industry are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government. The Secretary of State has said, "Divisive policies undermine good community relations, and harm the economic security of families by pushing up council tax. We need to challenge and prevent the politics of division."

3.8 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 already require administering authorities to publish and follow a statement of investment principles, which must comply with guidance issued by the Secretary of State. The draft replacement Regulations include provision for administering authorities to publish their policies on the extent to which environmental, social and corporate governance matters are taken into account in the selection, retention and realisation of investments. Guidance on how these policies should reflect foreign policy and related issues will be published ahead of the new Regulations coming into force. This will make clear to authorities that in formulating these policies their predominant concern should be the pursuit of a financial return on their investments, including over the longer term, and that, reflecting the position set out in the paragraph above, they should not pursue policies which run contrary to UK foreign policy.

Investment

3.9 A few definitions and some aspects of regulation 3, which describes what constitutes an investment for the purpose of these regulations, have been updated to take account of changing terminology and technical changes since the regulations were last issued in 2009. For example, the reference to the London International Financial Futures Exchange (LIFFE) has been removed as it now operates as a clearing house and so is covered by the approved stock exchange definition.

3.10 Some additional information has been included to make clear that certain investments, such as derivatives, may be used where appropriate. The Government expects that having considered the appropriateness of an investment in their investment strategy statement, authorities would only use derivatives as a means of managing risk, and so has not explicitly stated that this should be the case.

Questions

1. Does the proposed deregulation achieve the intended policy aim of removing any unnecessary regulation while still ensuring that authorities' investments are made prudently and having taken advice?

2. Are there any specific issues that should be reinstated? Please explain why.

3. Is six months the appropriate period for the transitional arrangements to remain in place?

4. Should the regulation be explicit that derivatives should only be used as a risk management tool? Are there any other circumstances in which the use of derivatives would be appropriate?

Proposal 2: Introducing a safeguard - Secretary of State power of intervention

Summary of the proposal

4.1 The first part of this consultation lifts some of the existing restrictions on administering authorities' investments in order to make it easier for them to pool their investments and access the benefits of scale. To ensure that this new flexibility is used appropriately, the consultation also proposes to introduce a power to intervene in the investment function of an administering authority if the Secretary of State believes that it has not had regard to guidance and regulations. The consultation sets out the evidence that the Secretary of State may draw on before deciding to intervene, and makes clear that any direction will need to be proportionate. The power proposed in this consultation is intended to allow the Secretary of State to act if best practice or regulation is being ignored, which will help to ensure that authorities continue to pursue more efficient means of investment.

4.2 The July Budget 2015 announcement set out the Government's intention to introduce "backstop" legislation to require those authorities who do not bring forward sufficiently ambitious plans to pool their investments. It also explained that authorities' proposals would need to meet common criteria, which have been published with draft guidance alongside this consultation. The draft power to intervene discussed in this paper could be used to address authorities that do not bring forward proposals for pooling their assets in line with the published criteria and guidance. The guidance will be kept under review, and will be revised as circumstances change and authorities' asset pools evolve.

4.3 The following sections set out the process for intervention described in draft regulation 8.

Determining to intervene

4.4 The draft regulations propose to give the Secretary of State the power to intervene in the investment function an administering authority, if the Secretary of State has determined that the administering authority has failed to have regard to the regulations governing their investments or guidance issued under draft regulation 7(1). In reaching that conclusion, the Secretary of State will consider the available evidence, which might include:

- Evidence that an administering authority is ignoring information on best practice, for example, by not responding to advice provided by the scheme advisory board to local pension boards.
- Evidence that an administering authority is not following the investment regulations or has not had regard to guidance published by the Secretary of State under draft Regulation 7 (1). For example, this might include failing to participate in one of the large asset pools described in the existing draft guidance, or proposing a pooling arrangement that does not adhere to the criteria and guidance.

- Evidence that an administering authority is carrying out another pension-related function poorly, such as an unsatisfactory report under section 13(4) of the Public Service Pensions Act 2013, or another periodic reporting mechanism. (Section 13(4) of the 2013 Act requires a person appointed by the Secretary of State to report on whether the actuarial valuation of a fund has been carried out in accordance with Scheme regulations, in a way that is consistent with other authorities' valuations, and so that employer contribution rates are set to ensure the solvency and long term cost efficiency of the fund.)

4.5 If the Secretary of State has some indication to suggest that intervention might be necessary, the draft regulations propose that he may order a further investigation to provide him with the analysis required to make a decision. If additional evidence is sought, draft regulation 8(5) would allow the Secretary of State to carry out such inquiries as he considers appropriate, including seeking advice from external experts if needed. In this circumstance, the administering authority would be obliged to provide any data that was deemed necessary to determine whether intervention is required. The authority would also be invited to participate in the review and would have the opportunity to present evidence in support of its existing or proposed investment strategy.

The process of intervention

4.6 If the Secretary of State is satisfied that an intervention is required, he would then need to determine the appropriate extent of intervention in the authority's investment function. The draft regulations propose to allow the Secretary of State to draw on external advice to determine what the specific intervention should be if necessary.

4.7 Draft regulation 8(2) describes the interventions that the Secretary of State may make. The power has been left intentionally broad to ensure that a tailored and measured course of action is applied, based on the circumstances of each case. For example, in some cases it may be appropriate to apply the intervention just to certain parts of an investment strategy, whereas in particularly concerning cases, more substantial action might be required. The proposed intervention might include, but is not limited to:

- Requiring an administering authority to develop a new investment strategy statement that follows guidance published under draft Regulation 7(1).
- Directing an administering authority to invest all or a portion of its assets in a particular way that more closely adheres to the criteria and guidance, for instance through a pooled vehicle.
- Requiring that the investment functions of the administering authority are exercised by the Secretary of State or his nominee.
- Directing the implementation of the investment strategy of the administering authority to be undertaken by another body.

4.8 The Secretary of State will write to the authority outlining the proposed intervention. As a minimum, this proposal will include:

- A detailed explanation of why the Secretary of State is intervening and the evidence used to arrive at their determination.

- A clear description of the proposed intervention and how it will be implemented and monitored.
- The timetable for the intervention, including the period of time until the intervention is formally reviewed.
- The circumstances under which the intervention might be lifted prior to review.

4.9 The authority will then be given time to consider the proposal and present its argument for any changes that it thinks should be made. If, at the end of that period an intervention is issued, any resulting costs, charges and expenses incurred in administering the fund would be met by the pension fund assets.

Review

4.10 As set out above, each intervention will be subject to a formal review period which will be set by the Secretary of State but may coincide with other cyclical events such as the preparation of an annual report or a triennial valuation. At the end of that period, progress will be assessed and the Secretary of State will decide whether to end, modify or maintain the current terms of the intervention, and will notify the authority of the outcome. The authority will also have the opportunity to make representations to the Secretary of State if it feels a different course of action should be followed. Throughout this period of intervention, the authority will be supported to improve its investment function, so that it is well placed to bring the intervention to an end at the first opportunity.

4.11 The Secretary of State's direction will include details about what is required of the authority in order to end the intervention, and how progress will be measured. Progress could, for example, be measured by creating a set of performance indicators to be monitored on an ongoing basis by Government officials, the local pension board, the scheme advisory board, or an independent body. A regime of regular formal reports to the Secretary of State could also be required.

4.12 The draft regulations also allow the Secretary of State to determine that sufficient improvement has been made to end the intervention before the review date. The administering authority may also make representations to the Secretary of State before that date, if it has clear evidence that the prescribed action is no longer appropriate.

Questions

5. Are there any other sources of evidence that the Secretary of State might draw on to establish whether an intervention is required?
6. Does the intervention allow authorities sufficient scope and time to present evidence in favour of their existing arrangements when either determining an intervention in the first place, or reviewing whether one should remain in place?
7. Does the proposed approach allow the Secretary of State sufficient flexibility to ensure that he is able to introduce a proportionate intervention?

8. Do the proposals meet the objectives of the policy, which are to allow the Secretary of State to make a proportionate intervention in the investment function of an administering authority if it has not had regard to best practice, guidance or regulation?

Summary of the draft regulations

(1) Citation, commencement and extent

This details the citation and scope of the draft regulations, and gives the date at which they will come into force.

(2) Interpretation

These provisions define terms used in the draft regulations with reference to legislation, and cite the legislation that gives administering authorities the powers that may be impacted by the draft regulations.

(3) Investment

This draft regulation defines what is considered an investment for the purposes of the regulations. This definition includes futures, options, derivatives, limited partnerships and some types of insurance contracts. It also defines who a person with whom a contract of insurance can be entered into is.

(4) Management of a pension fund

This draft regulation lists the monies that an administering authority must credit to its pension fund, including employer and employee contributions, interest, and investment capital and income. It also sets out the administering authority's responsibility to pay benefits entitled to members, and states that, except where prohibited by other regulations, costs of administering the fund can be paid by the fund.

(5) Restriction on power to borrow

This proposed regulation outlines the limited circumstances under which an administering authority can borrow money that the pension fund is liable to repay.

(6) Separate bank account

The draft regulation states that an administering authority must deposit all pension fund monies in a separate account, and lists those institutions that can act as a deposit taker. It also states that the deposit taker cannot use pension fund account to set-off any other account held by the administering authority or a connected party.

(7) Investment strategy statement

This draft regulation places an obligation on the administering authority to consult on and publish an investment strategy statement, which must be in accordance with guidance from the Secretary of State. The statement should demonstrate that investments will be suitably diversified, and it should outline the administering authority's maximum allocations for different asset classes, as well as their approach to risk and responsible investing.

In many respects, the investment strategy statement replaces the list of restrictions given in Schedule 1 of the 2009 Regulations and enables the criteria to be determined at local level. Schedule 1 of the 2009 Regulations will remain in force until such time that the new investment strategy statements have to be published.

Provision is made for authorities to publish their policy on the extent to which environmental, social and corporate governance factors are taken into account in the selection, retention and realisation of investments.

Separate guidance will be issued by the Secretary of State that will clarify how the Government's recent announcement on boycotts, sanctions and disinvestment will be exercised.

(8) Directions by the Secretary of State

This provision would grant the Secretary of State the power to intervene in the investment function of an administering authority if he is satisfied that the authority is failing to have regard to regulation and guidance. He can also initiate inquiries to determine if an intervention is warranted, and must consult with the authority concerned. Once it is determined that an intervention is needed, the Secretary of State can intervene by directing the authority undertake a broad range of actoins to remedy the situation.

(9) Investment managers

This draft regulation details how an administering authority must appoint external investment managers.

(10) Investments under section 11(1) of the Trustee Investments Act 1961

This draft regulation allows administering authorities to invest in Treasury-approved collective investment schemes.

(11) Consequential amendments

This proposed regulation lists the prior regulations that are amended by the draft amendments.

(12) Revocations and transitional provisions

The draft provision lists the regulations that would be revoked if the draft regulations come into effect. It also proposes transitional arrangements to ensure that the existing regulations governing the investment strategy remain in place until a new investment strategy statement is published by an authority under draft regulation seven. These transitional arrangements would apply for up to six months after the draft regulations came into effect.

Annex A: Members of the Investment Regulation Review Group

Alison Hamilton	Barnet Waddingham
Bob Claxton	Wandsworth Pension Fund
Clifford Sims	Squire Patton Boggs
Dawn Turner	Environment Agency Pension Fund
Geoff Reader	Bedford Pension Fund
Graeme Russell	Greater Gwent Pension Fund
Guy Sears	Investment UK
Loretta Stowers	Greater Manchester Pension Fund
Nick Buckland	Dorset Pension Fund
Nigel Keogh	Chartered Institute of Public Finance and Accountancy
Paul Dale	Bromley Borough Council
Peter Morris	Greater Manchester Pension Fund

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January 2016,
Scott Jamieson,
Head of Multi-Asset Investing

Market Backdrop

Introduction

This note is intended to support the discussion at the annual strategy review of the Leicestershire County Council Pension Fund (LCCPF). It will summarise developments over 2015 and review consensus economic and market expectations for the period ahead.

Consensus expectations – growth and inflation

The first table below details consensus forecasts[1] for real growth across the major economies for 2016 and 2017. If the consensus proves incorrect the likely direction of error is suggested. Also shown is the expected out-turn for last year together with the consensus forecast for 2015 taken one year ago.

With the exception of Europe, economic growth underperformed in 2015 despite the fall in the price of oil which was expected to buoy consumer spending through lower fuel bills. European activity exceeded expectations as QE delivered improved credit conditions and a weak € supported external demand.

For the US, external demand was lower than expected as the contraction in the oil and gas sector hit job growth. In the UK a strong currency kept growth contained but at 2.4% was very respectable in an international context. The Japanese economy has shown itself to be highly dependent on fresh policy stimuli; Japanese policymakers disappointed markets in 2015. Chinese growth is starting to falter under the burden of the currency peg (to a very strong US$), the natural maturing of its economy, contraction and defaults within the credit sector and weak global markets for its products.

Table 1: Consensus forecasts – Real GDP growth (%)

	2015	1 year ago	2016	Risk[2]	2017	Risk
US	2.5	3.0	2.5	↓	2.4	↓
Eurozone	1.5	1.1	1.7		1.7	
UK	2.4	2.6	2.2	↓	2.2	↓
Japan	0.6	1.0	1.1		0.7	↓
China	6.9	7.0	6.5		6.3	↓

The outlook for growth is broadly constructive. US and UK growth is expected to stabilise (at levels above trend potential) and modest increases in activity are expected in Europe (as the supportive conditions of 2015 persist) and Japan (as policy stimulus is added). China is the black spot as the trend in growth continues lower.

In recent years economists have generally proved too optimistic on growth overestimating the extent and durability of the final demand response to cheaper credit and lower energy bills; consumers have tended to increase savings rates. Meanwhile the corporate sector, across the globe, has persistently disappointed on capital expenditure. Fiscal policies are generally being tightened and this should ensure that, once again, error terms to growth are downward. That said, the world economy is still growing. Perhaps the biggest risk comes from weakening emerging economies.

The story on inflation is similar to growth – expectations for 2015 have generally not been delivered due to lower oil prices (Table 2). Agricultural commodity prices also fell sharply last year.

[1] Based on a range of forecasts provided by economists to Bloomberg
[2] Likely direction of a materially different result from expectation

Table 2: Consensus forecasts – Inflation (CPI, %)

	2015	1 year ago	2016	Risk	2017	Risk
US	1.3	1.7	1.6	↑	1.8	↑
Eurozone	0.1	0.6	1.0	↑	1.5	
UK	0.1	1.3	1.3	↑	1.9	↑
Japan	0.8	1.5	0.8	↑	2.0	↑
China	1.5	2.0	1.7		2.0	

As these price falls wash out of the data, headline consumer price inflation (CPI) is projected to return to around core levels. The forecasts remain below the policy target; projected inflation rates (further out) may put pressure on central banks to raise policy interest rates, actual inflation is not expected to be a problem.

Short and long term interest rates

Policymakers in the US and UK are expected to remain on the path toward 'normalisation' – the restoration of a positive real cash interest rate (Table 3).

Table 3: Consensus forecasts – main policy setting at year end

	2015	1 year ago	2016	Risk
US Fed	0.37%	0.95%	1.25%	↓
ECB[3]	-0.30%	-0.10%	-0.30%	↓
BoE	0.5%	1.00%	1.00%	↓
BoJ[4]	360T		440T	↑

This is far from the first year that normalisation has been forecast; it is the first after one of the major central banks having actually tightened (the US Federal Reserve). As a result changes to the forecasts are biased to the downside (in terms of policy tightening). While the US Fed may feel emboldened by their ability to raise rates without causing a more pronounced weakening in their economy (and thus be tempted to raise rates further), the pressure from a higher dollar will likely keep the more hawkishly minded in check.

The UK's BoE may be tempted to follow suit, given that wages are growing. With Sterling however still elevated, with fiscal policy remaining tight and with the EU referendum looming moving base rates higher, beyond a token gesture, looks unlikely.

The ECB and Bank of Japan remain firmly in easing mode and financial markets continue to reward those easing policy; indeed further stimuli look likely.

Longer term bond yields largely reflect the expected path of short term interest rates and inflation (Table 4).

[3] Deposit rate
[4] Target for monetary base, trillions of Yen

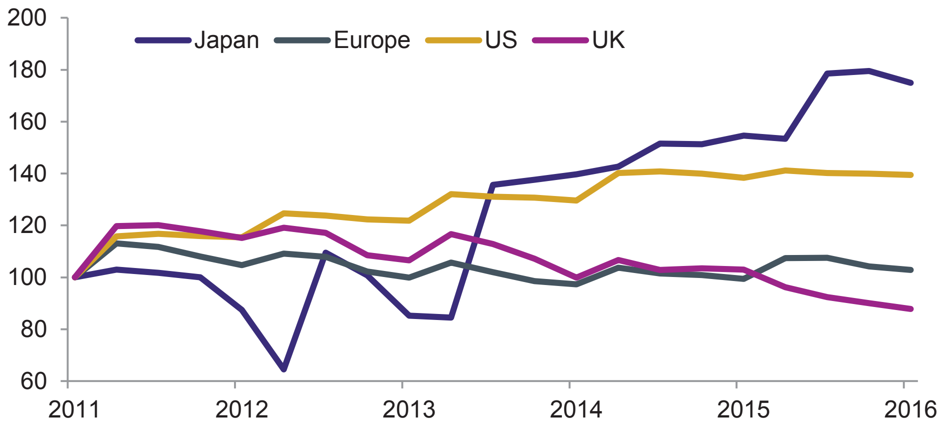
Table 4: Consensus forecasts – Ten year government bond yield at year end (%)

	2015	1 year ago	2016	Risk
US	2.3	3.0	2.8	↓
Eurozone	0.6	1.1	1.0	
UK	1.9	2.8	2.5	↓
Japan	0.3	0.6	0.5	

Equities

In assessing the outlook for equity markets it is useful to examine the trend in consensus forecast earnings per share (EPS). The chart below details the how the EPS for the UK, US, European and Japan equity markets have evolved over the past five years.

Chart 1: Forecast earnings per share (next financial year)



Source: DataStream

Earnings in the US have increased steadily over the past five years (supported by reasonable economic growth and the early restoration of health to the US banking system). That said, earnings are projected to 'flat-line' in 2016.

After some initial erratic performance the earnings outlook in Japan has improved markedly in recent years – this is 'Abenomics' in action. Once again some moderation is expected next year. In Europe corporate performance has been 'flat-lining' for some time. Although macro-economic policy has turned more forceful it is premature to conclude that this will feed through to higher earnings.

In the UK EPS have been softening for upwards of five years. Based on company statements, this weakness has been due to poor demand in Europe, the slump in commodity prices and the high level of £. Looking to 2016, Europe is expected to perform better, commodity prices are perhaps nearing a bottom and £ is unlikely to strengthen further.

Looking beyond the next financial year equity analysts are optimistic (Table 5). Although it should be remembered that analysts are rarely pessimistic, developed equity market earnings are expected to grow at a healthy pace and faster than nominal economic growth.

Table 5: Consensus EPS growth forecasts – second and third financial years (%)

	UK	US	Japan	Europe
FY2	5.1	6.8	8.8	6.5
FY3	13.6	12.8	8.0	11.6

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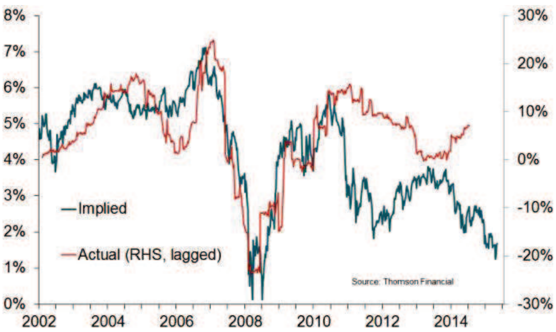
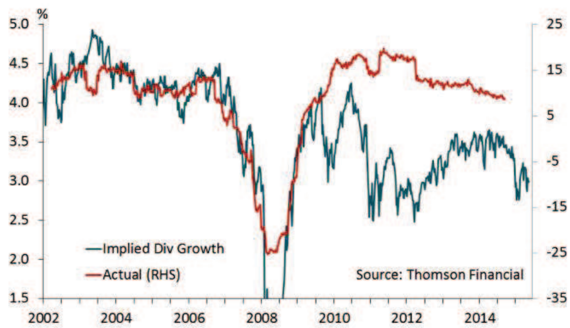
There are numerous ways of valuing equity markets. A preferred measure is the implied level of dividend growth required to break-even with the alternative of investing in government bonds (Charts 2 and 3). In both markets the required level of long-term dividend growth looks to be modest in absolute terms, against what has been delivered and finally also in nomimal terms. Equity markets should still be preferred to bonds.

Charts 2 and 3: UK and US implied dividend growth





Oil Prices

The slide in energy prices over the past 18 months (Chart 4) has been both an unexpected and significant ‘shock’ to the world economy. In market terms the most significant consequence has perhaps been the slump in energy-related high yield corporate bonds (Chart 5). The rate of defaults now implied suggests substantial weakness in the energy sector in the US; this will have a material impact on overall capital expenditure within the US economy.

Charts 4 and 5: Crude oil price (WTI, $ per barrel) and US High Yield energy index (total return)

Source: Bloomberg

The fall in energy prices has been fuelled by a surge in oil stocks (Chart 6) despite resilient demand (Chart 7). Higher oil prices will require oil production to fall; capacity reduction can be both a long and painful process. Investors – and policy makers - look unlikely to be challenged by higher energy costs in 2016.

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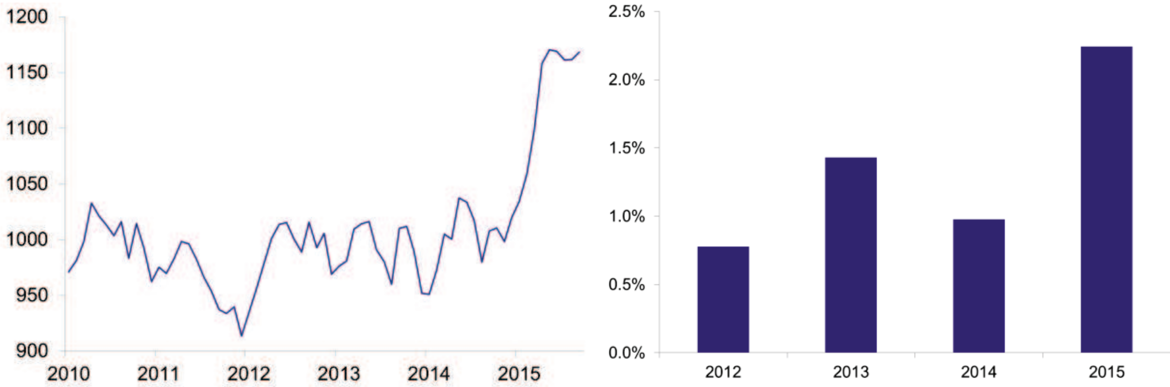
Charts 6 and 7: OECD Oil stocks (million barrels) and World demand (yoy growth)



Source: IEA

Summary

To the majority of economists the period ahead looks as it has often done at this time of year: economic growth will be reasonable without being remarkable, policy interest rates should rise gently - normalising - and while bond yields should also increase, the changes will be modest. Few see inflation lifting to the degree that would warrant aggressive rate hiking, indeed inflation rates are projected to remain at, or below, the policy target.

In past years (since the Global Financial Crisis) something has generally emerged to thwart this relatively comfortable scenario; last year it was Greece, China and oil. It is not coincidence that the error term has always been to the downside – the World remains debt obese and employment light. Behind all this there is an ever deepening demographic problem/crisis raising the cost of old age support.

In the year ahead headwinds may come from:

- China – it needs to detach itself further from the strong US$;
- Energy prices – at current prices the year-on-year adjustments will remain deflationary until H2;
- EU worries – centred on the British referendum and the French Presidential election (in 2017);
- Policy error – emboldened by their recent success the US Fed tightens too quickly;
- Defaults – developments in the US high yield bond market impact broader markets and
- Emerging markets – the funding problems evident in Brazil and South Africa deepen and spread.

Overall the likelihood is that 2016 will see the world avoid recession – easily, interest rates and bond yields will again fail to validate (rising) expectations while equities should deliver the best performance albeit in a volatile manner. In another low return year, 'best' may simply be due to the dividend payments.

Darker scenarios involve investors starting to penalise those markets/economies grown dependent on unbridled quantitative easing and also the highly problematic process by which cash investors try to transition back to their natural habitat from corporate bonds, equities and property.

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Agenda Item 8

Leicestershire County Council

LOCAL PENSION COMMITTEE – 22 JANUARY 2016

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

STRATEGIC INVESTMENT BENCHMARK AND PORTFOLIO STRUCTURE OF THE FUND

Purpose of the Report

1. To recommend changes to the Fund's strategic investment benchmark as outlined in the attached appendix to this report which has been written by Hymans Robertson, the Fund's investment consultant.

Background

2. The Pension Fund has long-term liabilities. The agreement of a strategic investment benchmark can, therefore, be based on the long-term expectation of returns within certain asset classes. Market fluctuations mean that the Fund's actual asset allocation will never exactly match the agreed strategic asset allocation and investment within asset classes in which funding is 'drawn down' over a period of time further confuses the position. The strategic benchmark should, therefore, be considered an 'anchor' around which the actual asset allocation is fixed.

Recommended Changes

3. The Fund's strategic asset allocation is still considered capable of producing the long-term investment returns that are required in order to avoid further increases to the full level of employer contribution rates that were calculated at the time of the 2013 actuarial valuation of the Fund. It should be noted that many employing bodies are paying contribution rates that are below these full levels (because their increases are being phased in), so actual employer contribution rates are likely to continue to rise for a number of years to come.

4. As the current asset allocation is still considered 'fit for purpose' there is no need to increase the target for future investment return and with it the level of risk that the Fund is taking. Likewise, there is no scope to reduce the risk (and hence the expectation for future investment returns) as this would have a negative impact onto the funding level that would see future employer contribution rates rise.

5. The recommended changes to the Fund's strategic benchmark are, therefore, relatively modest. It should generally be expected that year-on-year benchmark changes will be modest, so small changes are not unusual.

6. The Fund's current benchmark is shown in page 5 of the appendix, with a detailed breakdown of the quoted equity weighting at the top of page 16. With the exception of a recommendation to increase the Fund's exposure to infrastructure assets (see

below), the majority of the recommended changes relate to the split of the equity weighting.

7. At the Annual Strategy Meeting held in January 2015 a long-term regional benchmark was agreed, as follows:

Region	Percentage of regional equities
United Kingdom	20
Europe (Ex. UK)	15
North America	35
Japan	7.5
Pacific (Ex. Japan)	7.5
Emerging Markets	15

8. It should be noted that the above benchmark relates only to the *regional* equity split of the Fund. The Fund's other quoted equity portfolios – two global dividend-focused mandates – are managed against global market capitalisation weighted benchmarks and are not part of the above split.

9. In January 2015 it was agreed that a move would be made from the previous global equity benchmark split towards the above, long-term split but that the new benchmark would not be fully implemented. The major reason for this was that there still remained some doubts about corporate governance standards in Japan (where the Fund had no weighting within its strategic benchmark for a couple of years), although there had been a clear government-led improvement. The Fund effectively implemented a 50% 'wait-and-see' approach.

10. Over the last year it has become clear that the corporate governance improvements being made in Japan are real, and that maximisation of shareholder value is increasingly becoming accepted within the Country. As a result, it is recommended that the full Japanese equity weight be implemented and that the other regions also be brought into line with the previously agreed long-term regional benchmark.

11. The impact of the recommendation to fully move to the long-term regional split is more easily seen when the benchmark is expressed as a percentage of total Fund assets, rather than as a percentage of regional equities:

Region	Current % of total assets	Recommended % of total assets
United Kingdom	11.0	8.1
Europe (Ex. UK)	6.5	6.1
North America	13.0	14.2
Japan	1.5	3.0
Pacific (Ex. Japan)	3.0	3.0
Emerging Markets	5.5	6.1
	40.5	**40.5**

12. Although all of the regions will see some change to their benchmark weightings, most of them are relatively small. In broad terms a reduction in the UK equity weighting will fund increases in Japan and North America, whilst a small reduction in Europe will be offset by a slightly larger increase in emerging markets. More

detail on the rationale behind the regional split and the recommended movements can be found within the appendix.

13. All of the above changes can be achieved by amending the benchmark of Legal & General Investment Management (LGIM), and without the need to disrupt other portfolios. LGIM run large, pooled indexed funds where there are often crossing opportunities with their other clients. It is expected that the change can be gradually implemented, using crossing opportunities wherever possible, over two months (so that the new benchmark is fully in place before the end of March) at a low cost.

14. The only other recommended benchmark change is to increase the Fund's target weighting in infrastructure from the current 3% to 5%, to be funded by a reduction in the targeted return weighting (specifically Pictet's portfolio). The appendix fully explains why this change is considered appropriate.

15. One of the problems with infrastructure is that it often takes a significant period of time between committing capital and actually getting the capital invested. Many infrastructure deals are also currently being transacted at prices that could be considered 'rich'. In order to try to alleviate these potential pitfalls, it is recommended that the Investment Subcommittee be asked to consider the options available in terms of increasing the weighting in the most effective way possible. Until such time as any additional monies are invested within infrastructure, the monies will remain invested with Pictet. It may ultimately be possible to finance some of the future additional infrastructure investments by utilising the Fund's normal cashflows, but this will depend on timing and the nature of how the future investment will be made.

Summary

16. The proposals included in the appendices to this report should be viewed as evolution rather than revolution. They take account of the short and medium-term outlook for markets, as well as the long-term outlook that is enshrined within the strategic benchmark.

Recommendations

16. The Committee is recommended to:

    a. Approve a revised strategic benchmark for the Fund as shown on page 15 of the appendix to this report;

    b. Approve a revised regional equity split for the Fund as shown in paragraph 11 of this report;

    c. Request that the Investment Subcommittee review the optimal manner to increase the Fund's infrastructure weighting from 3% to 5%.

Appendix

Annual review of asset strategy and structure – Hymans Robertson LLP

Equal Opportunities Implications

None specific.

Background Papers

None.

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Annual review of asset strategy and structure

Addressee

This paper is addressed to the Local Pension Committee (LPC) of Leicestershire County Council Pension Fund ("the Fund"). The purpose of this paper is to provide the 2016 annual assessment of the Fund's investment strategy and its implementation in the context of the required return, current market conditions and LGPS investment reforms.

Executive Summary

Required return

The Fund is structured to deliver a blend of diversified return sources, with an emphasis on long-term investment and an element of inflation linkage. The expected real return over CPI is currently around 3.9% p.a.

Based upon the results of the 2013 valuation we estimated that the required return above CPI inflation on Fund assets is likely to be in excess of 4% p.a. (after expenses), to avoid the need for further employer contribution increases that are over-and-above those assessed at the time of the 2013 actuarial valuation. It should be noted that most employing bodies are currently paying lower employer contribution rates than the full level that was assessed in 2013, so there is an inevitability that rates will rise from their current levels anyway. With real interest rates having fallen since 2013, and assets not having delivered the expected outperformance relative to gilts, the required return will, if anything, be slightly higher now.

However, we do not propose the need for any wholesale change in the target level of return, especially if there is also an expectation of some real yield reversion, (i.e. gilt yields to rise towards what are thought to be more reasonable long-term levels) and certainly would not suggest targeting a more risky strategy ahead of the 2016 valuation.

LGPS reforms

The Chancellor's 2015 Autumn Statement contained detail on the government's proposals for the reform of the approach to the investment of LGPS assets, and in particular the use of asset pooling across LGPS in England and Wales via six so called "British Wealth Funds" ("BWFs").

Each Authority is expected to "join" one of the BWFs for the vast majority of its assets, retaining only a limited number of existing assets outwith the pooling arrangements where this can demonstrate value for money.

Strategic asset allocation will remain a local decision for the administering authority and pensions committee. However, there seems to be some flexibility in relation to deciding what decisions will be taken by the pool which will be taken locally at individual fund level. This means funds will need to determine the principles or beliefs they wish to maintain, and to consider in their proposals the extent to which this is achieved through their choice of BWF.

It is expected, albeit not certain, that the extent to which each authority or pool uses passive management will remain their own decision, but the balance between active and passive should be kept under review to ensure that active management is delivering value for money. Conversely, there is a very emphatic statement that 'manager selection will need to be undertaken at pool level'.

Market Conditions

Our concern remains that the level of interest rates implied by long-dated gilt yields (c2.0% to 2.5% p.a. between 25 and 50 years' time, having peaked at 3.5% in 15 years' time) are too low, particularly relative to market priced implied RPI inflation in excess of 3.25% p.a. over the same period and a consensus view that growth remains relatively robust at over 2%.

The picture for US inflation and growth is very similar, with a little more upside in growth expected before it moderates to a similar level to that predicted for the UK. Even Consensus forecasts for Japanese inflation and economic growth are on a slightly upward trajectory, albeit from a lower starting point.

In this environment the outlook for equities is equally uncertain and this has been reflected in market volatility. A marginal boost from revaluation (i.e. a rise in P/E ratio) has been offset by lacklustre earnings growth, which appears to have flat-lined globally over the last three years, although this varies considerably across regions. Credit spreads have also widened over 2014 after a period of sustained narrowing

In this environment, we continue to consider shorter-dated debt and secure income assets, where there is reasonable visibility of returns above cash, to provide relative attraction.

Recommendations

We do not see the need for any fundamental changes to the Fund's strategy. The recommendations we make this year continue to be an evolution of the existing strategy.

We recommend the following:

Equities

- Following the introduction of an allocation to Japanese equities made last year, we recommend increasing the allocation to Japan to 7.5% of the regional equity allocation, i.e. a "full weight" in line with the long-term benchmark allocation;
- Also in line with the long-term benchmark allocation proposed last year, we recommend funding this change through a further reduction in the bias to market cap weighted UK equities;
- Some modest reallocation of the regional allocation to be carried out to bring it into line with the long-term target allocation;
- In addition, we recommend the Fund consider the introduction of a global equity mandate with a growth bias to sit alongside the income mandates, or replacing one of the income mandates. This will give better diversification to sources of return in the equity portfolio than the current inherent factor biases. We would expect exposure to be achieved through active management rather than a passive index. However, we also note that implementation be considered alongside the route for LGPS pooling chosen by the Fund, rather than as a stand-alone exercise now.

Real Assets

- Recognising the reduced allocation to real assets, following the removal of the Fund's commodity mandate, we propose that the Fund increases its target allocation to infrastructure to 5%.
- As a next step we recommend exploring further investment in the IFM fund and/or co-investment options with KKR. We also suggest investigating one or two new open-ended funds that would fit with the Fund's existing arrangements. However, we also note that any decisions should be mindful of the evolution of LGPS pooling proposals and in particular the impact that these may have on any infrastructure investment and future opportunities to invest in infrastructure. Again, this may suggest considering implementation alongside broader progress on pooling, rather than progressing in isolation.

Prepared by:-

Andy Green, Partner
January 2016
For and on behalf of Hymans Robertson LLP

Risk warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

1. Fund Asset Allocation

The asset allocation and structure of the Fund is structured to accommodate the need for both the long-term return requirements (primarily equities and alternatives) and a degree of inflation linked returns, given the nature of the liabilities.

Details of the current target allocation are shown in the table below:

Equities (50.5-52.5%)

	Manager	Target %
UK	LGIM	11.0
Regional	LGIM	24.0
Global	Kempen	4.0
	Kleinwort Benson	4.0
Emerging	LGIM	5.5
	Delaware	
Private	Adams Street	4.0

Real Income Assets (22.5%)

Inflation Linked (12.5%)

	Manager	Target %
Index-linked	Implemented	7.5
Infrastructure	IFM	3.0
	KKR	
Timberland	Stafford	2.0

Property (10%)

	Manager	Target %
Fund of Funds	Aviva	5.0
Direct	Colliers	5.0

Alternative (25-27%)

	Manager	Target %
Targeted		
	Ruffer	7.0
	Aspect	4.0
	Pictet	2.5[1]
Overlay		
	Millenium	-
Other opportunities		
EM Debt	Ashmore	2.5
Credit Opps	JPM UK Financing Fund Partners	5.0
Other opp. pool	M&G	4.0-6.0
	Kames Property	
	Markham Rae	

1. The Pictet Dynamic Asset Allocation Fund allocation is largely a result of removing the commodities allocation.

The lower end of the equity range (50.5%) will only be reached if the opportunity pool investments reach the full weighting of 6%. Until the opportunity pool investments exceed 4%, the strategic equity weighting to equities will be 52.5%.

The asset allocation outlined above contains a diversified range of sources of return. Across the strategies, the Fund has exposure to the following sources of return and risk:

- Corporate growth
- Government risk
- Interest rates
- Inflation
- Active management
- Illiquidity premium
- Complexity premium

Required rate of return on assets

The value placed on the Fund's liabilities is determined by measuring the discounted value of the benefits to be paid in the future for accrued benefits. Based on the most recent actuarial valuation (31 March 2013), the value placed on liabilities was £3,652 million. The value placed on assets in the valuation is their prevailing market value. At the valuation date, the value of assets was £2,628 million, so the Fund was 72% funded at that time.

Based upon the results of the 2013 valuation we estimated that the required return above CPI inflation on Fund assets is likely to be in excess of 4% p.a. (after expenses), to avoid the need for further employer contribution increases relative to the full rates that were assessed as part of the actuarial valuation. It should be noted than most employers are currently paying contribution rates that are below these full rates, so there are further rises that are already expected.

With real interest rates having fallen since 2013, and assets not having delivered the expected outperformance relative to gilts, the required return will, if anything, be slightly higher now, or the current strategy will take longer to restore funding.

However, we do not propose the need for any wholesale change in the target level of return, especially if there is also an expectation of some real yield reversion, and certainly would not suggest targeting a more risky strategy ahead of the 2016 valuation.

Strategic forecast return

As noted in previous reports, this real return target applies at the aggregate Fund level. It does not require every asset and mandate held by the Fund to deliver returns at this level, and the investment policy should reflect a combination of return sources that balance the need to generate return with the benefit of diversification of returns. In the table below we set out the target contribution from each component of the strategy to the overall objective.

	Benchmark weight (%)	Long-term Real Return (% p.a.)	Contribution to Strategic Return (% p.a.)
Equities (52.5%)			
Listed equity	48.5	4.3	2.1
Private equity	4	6.5	0.3
Real (22.5%)			
Inflation linked bonds	7.5	0.3	0.0
Infrastructure	3	3.8	0.1
Timber	2	3.3	0.1
Property	10	2.7	0.3
Alternatives/Diversifiers (25%)			
Targeted return	13.5	4.0	0.5
EMD	2.5	3.0	0.1
Global Credit	5	4.0	0.2
Opportunity Pool	4	4.3	0.2
Currency overlay (Notional weight)	(13)	1.0	0.1
TOTAL	**100**		**3.9**

Although this is based on our subjective views of long-term strategic returns, it highlights where the main sources of return are expected to be generated.

The overall return is expressed relative to CPI. A real return (after expenses) of 4% delivers the required return. Disciplined re-balancing should be sufficient to add a modest amount to returns, bringing the overall return above 4% p.a.

2. LGPS pooling and impact on the Fund's decision making and asset implementation

The Chancellor's 2015 Autumn Statement contained detail on the government's proposals for the reform of the approach to the investment of LGPS assets, and in particular the use of asset pooling across LGPS in England and Wales via six so called "British Wealth Funds" ("BWFs") or asset pools.

The extent of the proposals will fundamentally change the way in which LGPS assets are invested, even if it does not actually affect the high level strategic allocation. In principle, each Authority is expected to "join" one of the BWFs for the vast majority of its assets, retaining only a limited number of existing assets outwith the pooling arrangements where this can demonstrate value for money.

There may be scope to use more than one BWF, although this will depend upon the evolution of the pools, and is as yet unclear.

Existing illiquid investments, where there would be a penalty for disinvesting assets, are likely to be kept outwith pooling, although there may be some asset specific pools that would enable Funds to pool even some of the illiquid assets, such as property or infrastructure. It is not, however, expected that significant levels of assets can be kept out of the pools in the long-term – for example closed-ended private equity funds may be allowed to mature outside of the pools, but any new investment in private equity after the pools have been established is unlikely to be acceptable.

Timetable and Proposals to government

By **19th February 2016** Authorities must submit initial proposals including commitment to pooling, and describing 'progress towards formalising arrangements'. These submissions can be individual or joint with other Funds/BWFs or both.

By **15th July 2016** Authorities must make final submissions that fully addresses the criteria set out below, with enough information for the proposal to be evaluated by government. Each pool must make a submission which covers the joint proposals and describes the proposed governance, structure and implementation plan. Each authority must submit an individual return which sets out the profile of costs and savings, the transition profile for the assets and the rationale for any assets which it proposes to hold outside the pool.

There is a consultation on modernisation of investment regulations which will also facilitate pooling – this also requires a response by **19th February 2016**.

Criteria for pooling of assets – not subject to consultation

The DCLG document entitled **Local Government Pension Scheme: Investment Reform Criteria and Guidance** sets out the criteria that will be applied to proposals for the pooling of assets. In brief:

1 **Achieve the benefits of scale** – up to 6 asset pools, each of £25bn or more.

2 **Strong governance and decision-making** – investments managed appropriately by the pool, risk adequately assessed and managed. Pool to have appropriate resources and skills. Local authority to hold the pool to account.

3 **Reduced costs and excellent value for money** – pools need to deliver substantial savings in investment fees, both in the near term and over the next 15 years while at least maintaining investment performance.

4 **An improved capacity to invest in infrastructure** – proposals should show how the pooling arrangements will enable the funds to invest more in infrastructure and drive local growth (LGPS currently has approximately 1% of total assets invested in infrastructure although we note that the Fund has a 3% allocation).

These criteria reflect the discussions that have taken place with Treasury and DCLG since the first announcement of pooling in the 2015 Summer Budget.

Impact of pooling on the Fund's investment strategy, manager selection and implementation

Strategic asset allocation will remain a local decision for the administering authority and pensions committee. However, there seems to be some flexibility in relation to deciding what decisions will be taken by the pool (and, by implication, which will be taken locally at individual fund level) with the proviso that the pool has to deliver value for money.

We interpret this as meaning that the pool will decide, in consultation with the participating authorities, which decisions are made where and the range of asset choices the pool will offer.

This means that funds will need to determine the principles or beliefs that they wish to maintain, and to consider in their proposals the extent to which this is achieved through their choice of BWF in areas such as different choices for listed equity investment (UK, non-UK, manager style, active or passive), different approaches to the investment in bonds (traditional benchmarked approaches, multi-credit, absolute return) and the choice of external versus in-house investment if both are available in the same pool.

It is expected, albeit not certain, that the extent to which each authority or pool uses passive management will remain their own decision, but the balance between active and passive should be kept under review to ensure that active management is delivering value for money.

Conversely, there is a very emphatic statement that 'manager selection will need to be undertaken at pool level'. The expectation is that this will rationalise the number of managers used leading to lower investment fees.

It has also been made clear that there needs to be a good rationale for any assets that are to be held outside the pool. The expectation is that these will form a small proportion of the total assets and will be confined to existing investments. New allocations should be pooled to take advantage of the potential to share costs.

Authorities need to consider how they might get more direct access to infrastructure using the benefits of scale. They need to indicate how much they expect to be able to allocate to infrastructure in the future. We consider the Fund's allocation to infrastructure as part of this annual review.

Proposed changes to investment regulations – subject to consultation

The government has proposed the removal of Schedule 1 to the existing regulations which sets out specific limits on investments. The specific limits will be replaced by a "prudential approach". Each fund will be required to set out an 'investment strategy statement' which will in effect replace the current Statement of Investment Principles. The statement will be required to address risk, diversification, corporate governance, responsible investment and the authority's approach to pooling.

There will be 'backstop legislation' to deal with any authority which does not come forward with sufficiently ambitious plans to pool their investments. Draft regulation 8 in the investment regulations referred to above provides for the Secretary of State to intervene if an authority is:

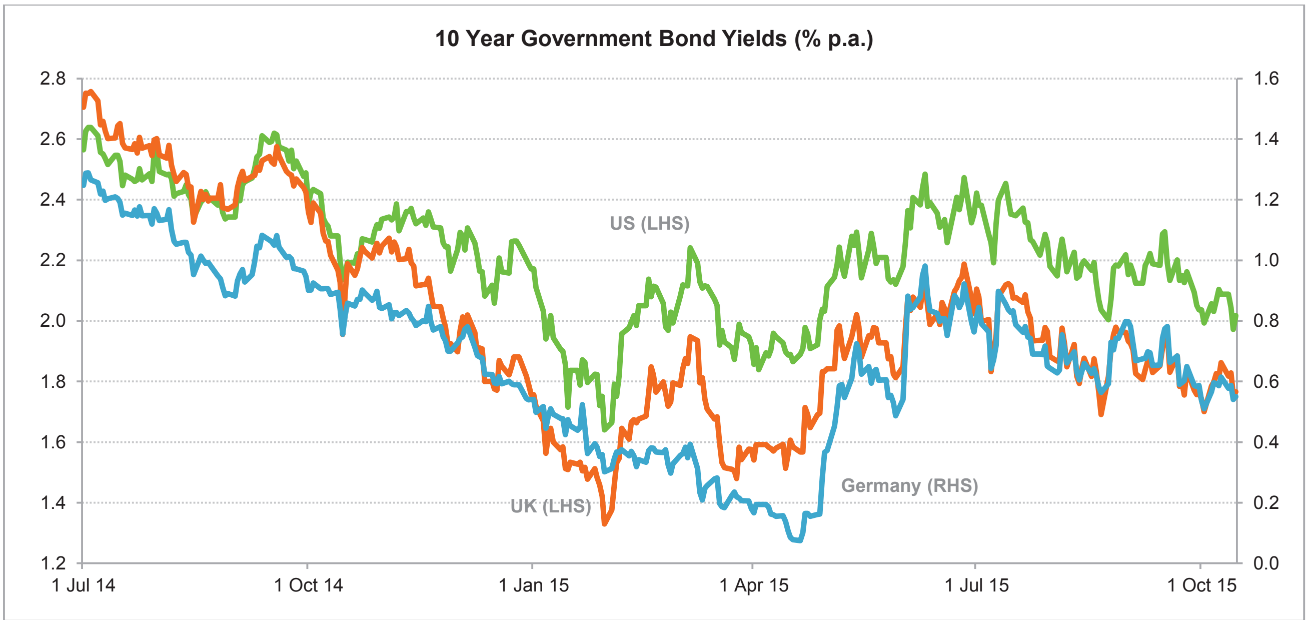
- Ignoring best practice;
- Is not following guidance, including not participating in one of the large asset pools or proposing a pooling arrangement that does not meet the criteria set out above;
- Carrying out another pension-related function poorly.

3. Market Commentary

The headlines following the publication of the November Inflation Report focused on the possibility that UK interest rates might not rise at all next year. The fact that gilt yields edged higher over the next few days suggests that did not come as a surprise to investors. UK rates are priced assuming no rise until early 2017.

Sitting geographically closer to Europe, the Bank of England takes a more jaundiced view of the outlook for overseas growth, particularly in emerging economies, in contrast to the more relaxed view the US Federal Reserve. The Bank also now thinks the effect of sterling strength in suppressing inflation will persist for longer.

The broad trends in gilt yields have largely mirrored those in US Treasury bonds; for all this year's fretting about a deteriorating global economic outlook and the deferral of interest rate rises, 10-year gilt, German Bund and US Treasury bond yields are all a little higher than they were at the end of 2014, albeit Gilt yields are c0.2% below Treasuries (left hand scale), and Bunds (shown on the right hand scale) 1.2% below that.



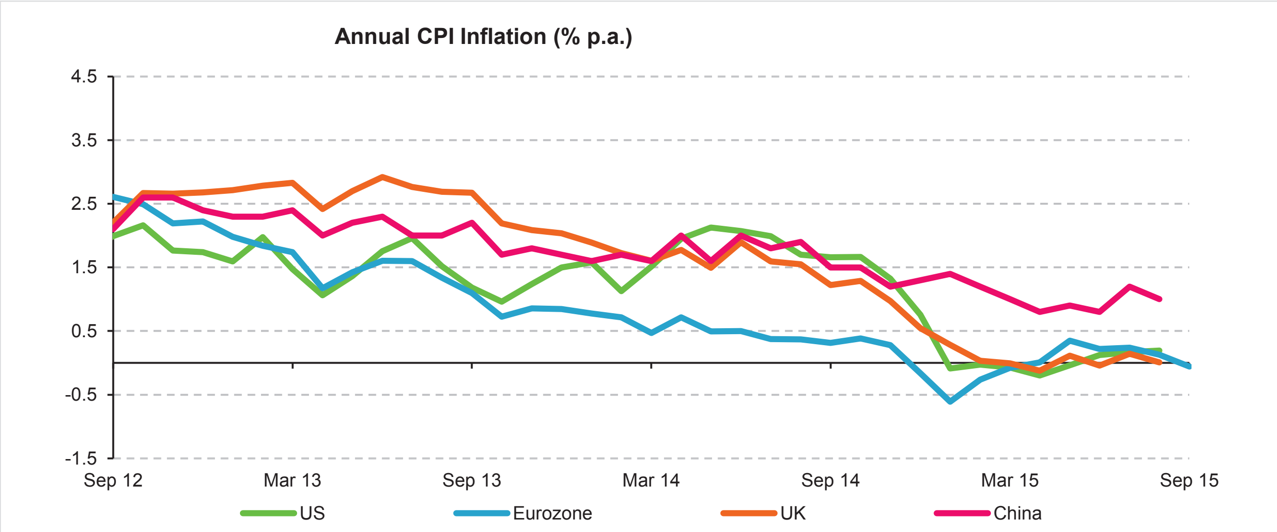
Our concern remains that the level of interest rates implied by long-dated gilt yields (c2.0% to 2.5% p.a. between 25 and 50 years' time, having peaked at 3.5% in 15 years' time) are too low, particularly relative to market priced implied RPI inflation in excess of 3.25% p.a. over the same period.

GDP growth in the UK is running at c2.5%, and although expected to moderate, Consensus forecast is that it remains relatively robust at over 2%.

CPI inflation is currently very low, but anticipated to rise to c2% over the next couple of years, suggesting nominal growth marginally in excess of 4% per annum.

Even if inflation and nominal growth come in a bit below these levels, it seems compatible with interest rates higher than the 2½% p.a. implied by long dated gilts. In short, only long-term economic performance that is very disappointing appears to justify current projected progress of government bond yields and there is a reasonable possibility that yields will need to rise (and hence capital values fall) by more than this at some stage in the future.

The picture for US inflation and growth is very similar, with a little more upside in growth expected before it moderates to a similar level to that predicted for the UK. Even Consensus forecasts for Japanese inflation and economic growth are on a slightly upward trajectory, albeit from a lower starting point.



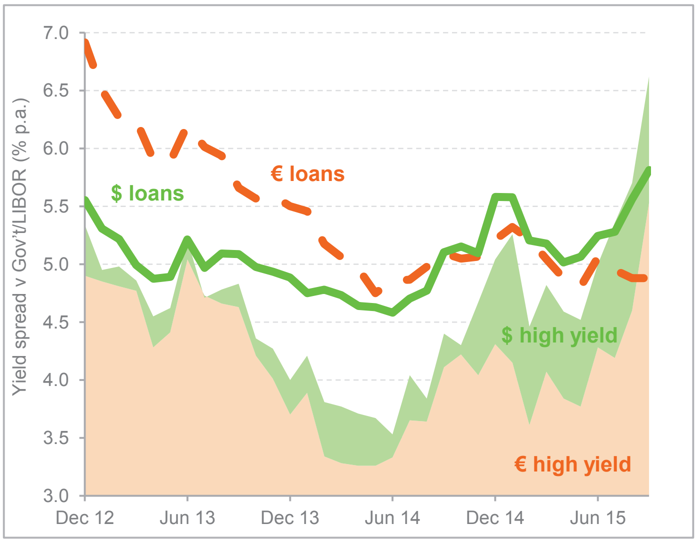
In this environment of uncertain growth, inflation and interest rates the outlook for equities is equally uncertain and this has been reflected in market volatility, even though at a global level, measured in $ terms, equities have more or less returned income and nothing else over the last few years. A marginal boost from revaluation (i.e. a rise in P/E ratio) has been offset by lacklustre earnings growth which appears to have flat-lined globally over the last three years, albeit this varies considerably across regions.

Overall payout ratios (i.e. dividends as a proportion of earnings) remain in line with the long-term average, just under 50%. However, this varies by region; UK listed companies' earnings have not kept pace with dividends and the payout ratio for UK listed equities has reached 65%, which we would consider unsustainable relative to historic average of 52%

In the US, profits growth is positive, but has drifted downwards this year and revaluation has been starting to push ahead of earnings growth. Emerging market valuations continue to look less extended than those in developed markets, albeit with some discrimination necessary in identifying where the value lies.

Reflecting corporate uncertainty, yields on high yield debt and corporate syndicated loans have risen, despite underlying reference yields and interest rates falling. The rise in yields has been more pronounced in the US, where energy related companies reflect a higher proportion of the market (14% vs 5% in Europe).

As a result, relative valuations in high yield bond markets are as cheap as they have been for a while – the last time yield spreads were this high was around two to three years ago. However, valuations are only cheap in an absolute sense to the extent that central bank interest rate policy keeps yields on all bonds below historic levels.



4. Equities

Current structure

The Fund's benchmark equity allocation is largely invested in listed equity markets (48.5%) with a further 4% of the Fund invested in private equity. The listed equity allocation comprises:

- a passive regional allocation;
- an allocation to passively managed fundamental (i.e. valuation based) indices in US and Europe;
- 2 active global income mangers;
- an active emerging markets manager.

Recommendations

We recommend the Fund makes the following changes to the portfolio:

- There are clear signs that corporate governance within Japan is greatly, after many years of companies failing to demonstrate they were actually prioritising shareholder value. Following the introduction of an allocation to Japanese equities made last year, we recommend increasing the allocation to Japan to 7.5% of the regional equity allocation, i.e. a "full weight" in line with the long-term benchmark allocation;
- Also in line with the long-term benchmark allocation proposed last year, funding this change through a further reduction in the bias to market cap weighted UK equities;
- Some modest reallocation of the regional allocation to bring it into line with the long-term target allocation proposed last year;

These changes are set out in the table below:

Mandate	Current benchmark %	Proposed benchmark %
L&G UK equity (market cap)	5	2.5
L&G UK equity (capped weights)	6	6.0
L&G Europe ex UK (market cap)	3.25	3.0
L&G Europe ex UK RAFI	3.25	3.0
L&G N America (market cap)	6.5	7.0
L&G N America RAFI	6.5	7.0
L&G Asia Pacific (market cap)	3	3.0
L&G Japan (market cap)	1.5	3.0
L&G Emerging Markets	1.5	2.0
Delaware Emerging Markets	4	4
Kempen Global equity income	4	4
Kleinwort Benson equity income	4	4
Total	48.5	48.5

In addition, we recommend the Fund consider the introduction of an actively managed global equity manager with a growth bias to sit alongside the income mandates, or if replacing one of the income mandates, to sit alongside the Kleinwort mandate. This will give better diversification to the equity portfolio's sources of return than the inherent factor biases in the current equity portfolio.

Implementation will need to be considered alongside the route for LGPS pooling chosen by the Fund.

The Fund's exposure to RAFI indices and equity income funds create an inherent bias towards 'value' within the Fund's equity portfolio. In order to give better diversification to the equity portfolio's sources of return, we recommend the Fund consider the introduction of a global equity mandate with a growth bias to sit alongside the income mandates, or if replacing one of the income mandates, to sit alongside the Kleinwort mandate.

We would expect exposure to be achieved through active management rather than a passive index, where growth biases solutions are limited. There is, however, a risk that the appointment of such a manager will turn out to be a short-term appointment of no more than 2 years given full implementation of the LGPS asset pooling is likely to be in place by this point, and there is no guarantee that the selected manager, or indeed the growth exposure, will be retained by the pool in which the Fund is involved. Hence, it may be sensible to defer implementation of this action at this stage and to enact it as part of the restructuring of assets when the pools are created or there is greater visibility around the construct of the pools.

5. Inflation protection assets

Until last year the Fund had a 25.5% target allocation to assets that are expected to deliver returns with a degree of inflation linkage, including the allocation to index-linked gilts. During the year the Fund exited its holding in commodities, and as such the target allocation has reduced to 22.5%. The proceeds have been invested in the Pictet Dynamic Asset Allocation fund, which invests in a broad mix of assets, primarily equities and bonds, pending other more attractive investment opportunities arising. The actual holding is a little lower than 22.5%, at 21%, due to current underweight holdings in index-linked gilts, timber and infrastructure (the underweighting of the two latter asset classes is due to there being undrawn commitments).

It would be ideal to increase the allocation to long-term real income based assets, given the long-term real nature of the liabilities. This said, the Fund should only invest in real assets when it can earn sufficient reward for its capital, and the demand for many assets in this category remains relatively strong, limiting relative value.

We see little reason to increase the strategic allocation to index-linked gilts given current yields; the current marginally underweight position can be corrected using natural cash flows of the Fund.

Equally, while we like a number of aspects of property markets, this mainly applies to the much lower yielding “safe” assets, that provide an alternative to index-linked gilts. Further detail is included in Appendix 3. For most of these assets the expected return is lower than the Fund’s target return, and while it would be possible to switch some of the Fund’s index-linked gilts into these assets it would have limited impact on the return at the overall level, but would lose access to liquidity. The core property market continues to be reasonably priced, but not especially good value from here. Hence, we also see no reason to amend the property allocation.

Turning to infrastructure, many parts of the market are also fully valued, especially in respect of some of the core regulated markets. However, we continue to see managers identifying specific opportunities at development stage or as active management opportunities, where prospective returns remain attractive. Hence, we propose that the PFMB target a more meaningful higher strategic weight to infrastructure assets of 5.0%, up from the current 3%. This will bring the strategic target to real assets up to 24.5%.

It should be noted that managing exposure to illiquid assets when they are expressed as a percentage of total assets is somewhat imprecise in nature as the allocation cannot be increased or reduced quickly; this is particularly so when the investment is via closed ended funds, where an initial commitment is only ‘drawn down’ as-and-when underlying opportunities are found by the manager.

At present the Fund has an actual weighting of c.2.6% in infrastructure (current target weighting of 3%), but with undrawn commitments of a further 1% of assets ($45m). When these undrawn commitments are invested, the Fund’s actual asset allocation will depend on the relative performance of infrastructure against other asset classes and the level of distributions from the KKR I Fund; it is not inconceivable that the weighting could reach 4% (if infrastructure outperforms), but it equally has a chance of remaining below 3% (if other assets perform better).

In Appendix 4 we set out thoughts on how increasing the allocation to 5% could be achieved. In summary, given the central focus on achieving value for money and further investment in infrastructure, we believe the Fund should continue to invest in directly held infrastructure funds, rather than using fund of funds. Options include

- allocating more to the existing IFM fund, subject to availability;
- although the KKR Fund I and II are now fully closed, KKR do offer clients co-investment opportunities;
- as outlined in Appendix 4, a number of managers, including some of the Fund’s existing managers for other mandates, provide open ended infrastructure funds if a third manager option is preferred for increasing exposure.

We propose that the Investment Sub-Committee is tasked with exploring these options for the Fund. As infrastructure investing is a key pillar of the Government's targeted outcomes we expect the landscape for LGPS infrastructure investing to continue to evolve through the likes of the Pension Infrastructure Platform ("PIP") and the new BWFs. The LPC will need to decide whether to allocate to existing funds or wait for a clearer picture on how infrastructure offerings develop in the post reform environment.

We also believe there may be merit in considering more targeted infrastructure funds as part of the Opportunities pool. We are seeing a number of smaller funds within the renewable energy area, typically UK based, providing scope for high single digit returns.

6. Alternatives

Over the last year the Fund has made a number of new commitments and amendments to existing mandates in the Alternatives bucket:

1) The Fund made a £40m commitment to M&G's Debt Opportunities Fund III, having previously committed £35m to DOF I and £40m to DOF II. By early January 2016, DOF I and DOF II were fully invested and DOF III had drawn down almost £10m and has a healthy pipeline that suggests it will draw its capital relatively quickly.

2) The Fund made a $40m commitment to the new Markham Rae trade financing fund as part of the Opportunities Pool. Current indications are that the first transaction of this fund will be in March 2016, at which time approximately one third of the commitment ($13.4m) will be drawn.

3) The Fund switched the £25m holding in JPMorgan's Global Strategic Bond Fund to the Multi Sector Credit fund. The Multi Credit fund is more focused on higher yielding debt, with a commensurate higher long-term expected return, and the Fund also benefited from a nil cost transition and a heavily discounted fee.

4) The Fund switched the £30m Pictet absolute return fund holding to the new Dynamic Asset Allocation Fund, which has a higher return target, and the Fund benefited from a heavily discounted fee.

   In addition the proceeds of the Investec commodities fund (£56m) were invested in the Pictet Dynamic Asset Allocation Fund.

   The Pictet holding, together with normal cash flows of the Fund, would be used to fund any increase in the Infrastructure allocation.

Other than continuing to identify additional investments for the Opportunities Pool, no further amendments are proposed at this time.

7. Summary of recommendations

The table below sets out our higher level strategic recommendations. The changes are highlighted in red.

	Current Benchmark weight (%)	Proposed Benchmark Weight (%)	Long-term Real Return (% p.a.)	Contribution to Strategic Return (% p.a.)
Equities (50.5 – 52.5%)				
Listed equity	46.5-48.5	46.5 – 48.5	4.3	2.1
Private equity	4	4	6.5	0.3
Real (24.5%)				
Inflation linked bonds	7.5	7.5	0.3	0.0
Infrastructure	3	5	3.8	0.2
Timber	2	2	3.3	0.1
Property	10	10	2.7	0.3
Alternatives/Diversifiers (23.0 - 25.0%)				
Targeted return	13.5	11.5	4.0	0.5
EMD	2.5	2.5	3.0	0.1
Global Credit	5	5	4.0	0.2
Opportunity Pool	4-6	4 - 6	4.3	0.2
Currency overlay (Notional weight)	(13)	(13)	1.0	0.1
TOTAL	**100**	**100**		**3.9**

In order to fund the additional infrastructure allocation, the PFMB will need to decide whether to increase the allocation now or wait for a clearer picture on how the BWFs' infrastructure offerings develop. If the PFMB wishes to progress this now, we propose that the Investment Committee is tasked with exploring the options. Funding for any additional allocation would be drawn from the Pictet Dynamic Asset Allocation fund plus normal cash flows, as previously discussed.

We also believe there may be merit in considering more targeted infrastructure funds as part of the Opportunities Pool.

In addition, within the equity portfolio, we recommend the following changes:

- increasing the allocation to Japan to 7.5% of the regional equity allocation, i.e. a "full weight" in line with the long-term benchmark allocation;
- funding this change through a further reduction in the bias to market cap weighted UK equities;
- Some modest reallocation of the regional allocation to be carried out to bring it closer into line with the long-term target allocation;
- In addition, we recommend the Fund consider the introduction of an actively managed global equity manager with a growth bias to sit alongside the income mandates, or replacing one of the income mandates. This will give better diversification to sources of return in the equity portfolio than the current inherent factor biases. However, we also note that implementation be considered alongside the route for LGPS pooling chosen by the Fund, rather than as a stand-alone exercise now.

Additional information

Appendix 1 – Equity benchmark;

Appendix 2 – Individual manager and RAFI analysis;

Appendix 3 – Property;

Appendix 4 – Infrastructure.

Appendix 1 Equity Benchmark

Background

Current structure

The Fund's benchmark equity allocation is largely invested in listed equity markets (48.5%) with a further 4% of the Fund invested in private equity.

Listed Equity Mandates	Current benchmark %
L&G UK equity (market cap)	5.0
L&G UK equity (capped weights)	6.0
L&G Europe ex UK (market cap)	3.25
L&G Europe ex UK RAFI	3.25
L&G N America (market cap)	6.5
L&G N America RAFI	6.5
L&G Asia Pacific (market cap)	3.0
L&G Japan (market cap)	1.5
L&G Emerging Markets	1.5
Delaware Emerging Markets	4.0
Kempen Global Dividend Kleinwort Benson Global Developed / GEM	4.0 4.0
Total	48.5

The listed equity allocation comprises both passive management (conducted by L&G), and active management, with the latter focused on Emerging Markets and two Global Income strategies.

The passive index funds include exposure to regional market capitalisation indices and regional fundamental indices (RAFI) in the US and Europe. Part of the UK equity allocation is invested in a market weighted index, where the maximum exposure to any one stock is capped, in order to reduce stock specific risk. RAFI aims to capture a premium in excess of the cap weighted equity return over time by tracking a broad index based upon fundamental valuation, which rebalances towards stocks trading on lower valuations.

Regional equities - Long-term neutral benchmark

The global market cap weighted allocation, the Fund's long-term regional benchmark allocation (as discussed in the January 2015 review) and the Fund's current regional equity benchmark allocation are summarised below.

Region	Market cap weight %	Long-term regional benchmark %		Current regional benchmark %
UK equity	6.7	20	35	24.0
Europe ex UK	15.9	15		16.0
N America	55.1	35	35	35.5
Asia Pacific x Japan	3.7	7.5	15	7.2
Japan	7.9	7.5		4.4
Emerging Markets	10.7	15	15	12.8
Total	100.0			100

The UK bias of the long-term regional benchmark at the expense of US equities will give the portfolio an element of value and dividend yield bias relative to the global market cap index. It also provides a slight sector bias to energy and financials at the expense of IT. The long-term regional benchmark also has greater exposure to the Emerging Markets growth and reduces the bias to mega-cap companies.

The Fund's current benchmark is similar to the long-term benchmark, with the exception of still having the lower weighting to Japan and Emerging Markets, and a larger bias to UK equities. The extent of the UK bias and Japan underweight were reduced last year, with the introduction of a "half-weighting" to Japan.

Equity beliefs

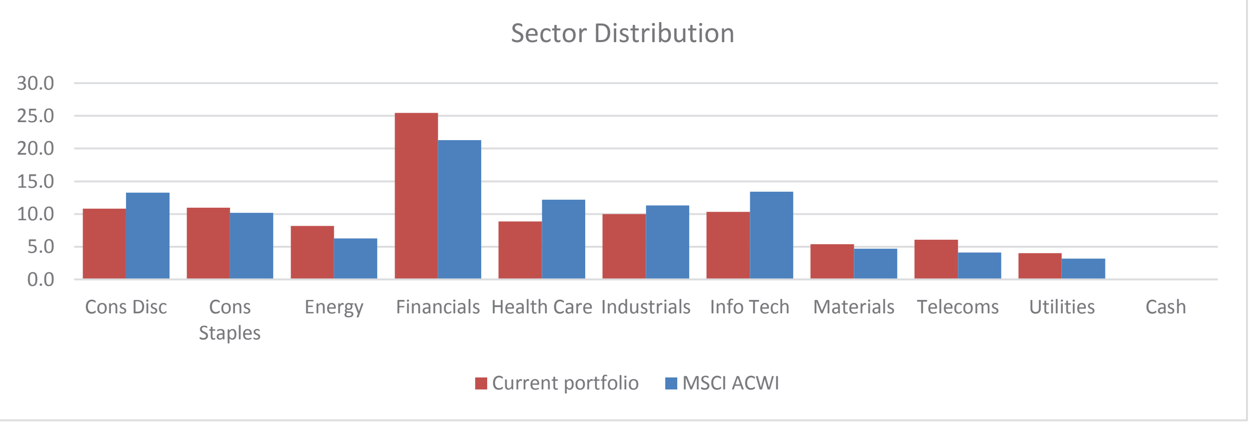
We set out below our core equity beliefs, which provide context for our comments that then follow on the current equity structure of the Fund.

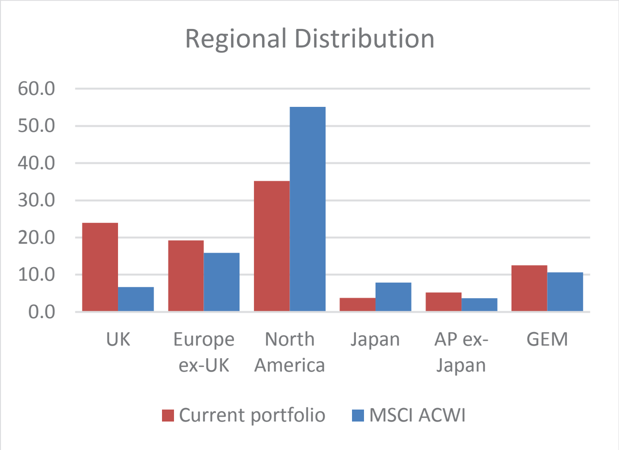
1. Passively managed market cap based investment has a core balancing role to play in most pension schemes' equity allocations, bringing liquidity, transparency and reducing average fee levels;
2. Market cap weighted indices have their drawbacks; adding carefully selected systematic, factor tilted equity strategies can improve risk-adjusted returns, and benefiting from disciplined rebalancing (the "rebalancing premium");
    - Even if outweighed by technical factors in the short-term, diversified exposure to valuation based factor tilts can add excess return per unit of risk over a reasonable timeframe;
    - Carefully selected exposure to growth strategies can improve the balance of overall equity exposure and improve risk adjusted returns;
    - A tilt towards medium and smaller sized businesses is generally rewarded over time;
3. Exposure to emerging markets provides diversification and the opportunity for higher returns due to the higher risk premium typically earned for investing in these markets;
4. With sufficient research and governance, active equity management can be incorporated to add value relative to market cap weighted indices; overall active equity exposure should be focused predominantly on stock-specific risk;

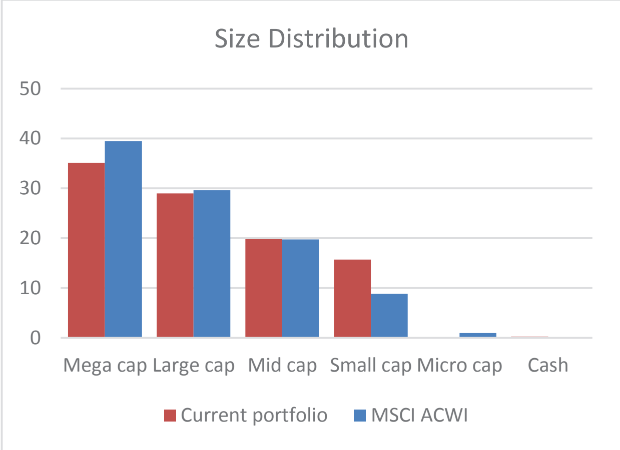
We believe that a combination of exposures that incorporates some or all of these investment beliefs enhances the risk adjusted return of investing in equities, net of fees, relative to passive investment in a global market cap index.

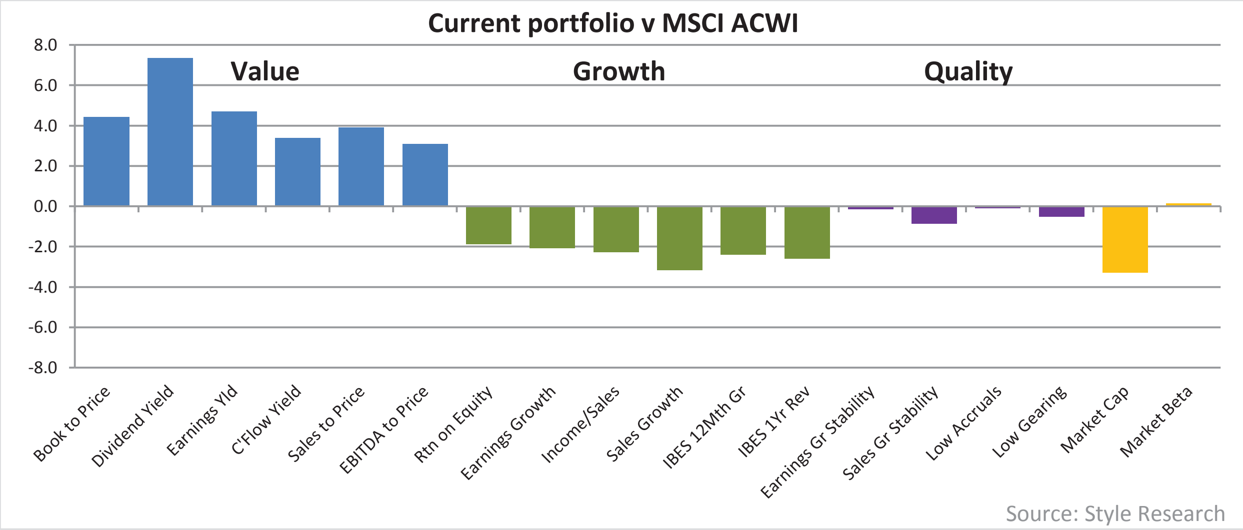
Current Fund style, sector, region and size analysis

In the charts below we compare the Fund's current portfolio with the market cap index.









Observations:

- Compared to the market cap index, the current portfolio is moderately overweight to the UK and underweight the US, Japan and Emerging Markets;
- The portfolio is biased away from mega-cap stocks and holds more in smaller cap stocks;
- The combined style biases introduced by RAFI and the active income manager allocations result in a persistent and significant tilt towards value, and away from growth stocks. Delaware is less factor biased (the individual manager and RAFI analysis is provided in Appendix 2);
- The portfolio has a bias away from long-term sustainable earnings growth and no positive quality bias.

We conclude that although the portfolio has a number of desirable features, the value bias is particularly strong, and there is a lack of quality and growth characteristics.

We believe it would achieve a better balance in the portfolio to introduce a growth focused global equity mandate. We would expect exposure to be achieved through active management rather than a passive index, where growth biases solutions are limited.

As highlighted in the main body of this report, there is a risk that the appointment of such a manager will turn out to be a short-term appointment given the LGPS asset pooling reforms, and hence, it would be sensible to defer implementation of this action at this stage and to enact it as part of the restructuring of assets when the pools are created or there is greater visibility around the construct of the pools.

UK equity allocation

Within UK equities, the agreement to make an allocation to UK mid-cap stocks from the FTSE All Share exposure has not yet been implemented as it has been challenging to identify a suitable entry point given the sustained outperformance of the FTSE Mid 250 Index. Unfortunately this trend has been extended over the past 12 months as the de-rating of commodity stocks has weighed heavily on several large cap stocks in the UK index.

The FTSE Mid 250 has outperformed the FTSE All Share by over 13% in the past 12 months and by circa 5% p.a. over the past 5 years. The FTSE Mid 250 price earnings ratio is only at a relatively narrow discount to the FTSE 100 p/e, compared with a greater difference historically. This reflects certain large cap share prices falling in anticipation of lower commodity related earnings in the future. However, looking at longer term averages we would conclude that the outperformance of the Mid 250 has been justified by relative progress in the earnings and dividends of its constituents.

The current equity structure already has a tilt away from large cap stocks and we do not think the FTSE Mid 250 is particularly materially cheap, and so we do not see the implementation of the 1% allocation to mid-cap stocks as a priority for the Investment Sub-Committee at this time.

Japanese equity allocation

The Fund introduced a 3.7% weighting to regional Japanese equities, half the 7.5% weighting in the long-term neutral allocation. The introduction of the half-weight to Japan reflected the renewed emphasis on improving corporate governance by the Japanese Government (although actual corporate governance in Japan, while improving, remains relatively poor).

The half-weighting was expected to be a directional move, to be increased to a full weighting once there is more sustained evidence of a move to better corporate governance in Japan. We believe the events of the last year provide evidence of progress.

As discussed in last year’s paper, the JPX-Nikkei 400 Index was launched in early 2014, which aimed to “name and shame” large Japanese companies with poor profitability (measured by return on equity, or “ROE”) by excluding these from this index. This index is primarily used as a “quality mark” by Japanese companies with limited take-up of this index as a benchmark for active or passive institutional investors, although the Japanese Government Pension Scheme (the largest in the world) has adopted this as its domestic equity benchmark. The turnover of this index remains relatively high, with c.10% of the 400 companies being replaced at each annual review to date.

A new Stewardship Code and Corporate Governance Code (heavily based on the UK equivalents) came into effect in June 2015, based on the principle of comply-or-explain.

In addition, one of the main proxy voting advisers (ISS) has adopted a policy of recommending a vote against top management in companies where the five year average ROE has been below 5%. As a result Japanese companies are experiencing sustained pressure to improve their corporate governance, financial performance and capital efficiency.

According to our conversations with investment managers, this has resulted in a number of companies making changes to their strategies, restructuring their businesses and providing better communication of these changes with shareholders in the months leading up to their AGMs. Others have been less well-prepared, and as a result had to quite hurriedly provide supplemental information in advance of AGMs and make senior executives available for sometimes difficult, last minute conversations in order to seek shareholder support for management at AGMs.

The most notable aspect of this has been the seriousness with which companies have treated these issues, with companies “reaching out” to their shareholders at an unprecedented scale (evidenced by speaking to investors for the first time, holding their first overseas investment roadshows, opening or expanding investor relations offices etc).

Finally, we note that Japan has outperformed other markets over the year to date. Although there may be many other underlying reasons, we note that these changes may well have made a contribution to improved stock market performance.

In conclusion, we believe there is sufficient evidence to increase the allocation to Japanese equities to its full strategic weight of 7.5%. We propose this further allocation is funded from UK equities, and continues to be invested in L&G’s FTSE Japan Index Fund.

Global Income

Since the appointment of the two active global equity income managers, Kleinwort Benson and Kempen, in late 2012, broad equity income indices have underperformed their standard market cap equivalents. This outcome has been driven primarily by their underexposure to low yielding but strongly performing US equities and an underlying tilt to value stocks which have materially underperformed growth stocks over the subsequent period.

	2015 Year to date (%)	1 Year (%)	3 Years (%)	3 Years Volatility (%)
MSCI ACWI	-4.3	0.4	9.4	9.9
MSCI ACWI High Dividend	-6.4	-4.4	6.5	10.0
MSCI ACWI Value	-7.3	-4.2	8.0	9.8
Kempen Global High Dividend	-3.2	-1.2	6.9	10.0
Kleinwort Benson ACWI Equity	-6.2	-2.0	9.4	10.0

Source: eVestment

Both of the Fund’s global equity income managers take a structured approach. Kempen confines itself to stocks yielding in excess of 3% and by and large evenly weights its portfolios of circa 100 stocks. Once these criteria are met, stock selection is based on fundamental research carried out by the small, Amsterdam based team.

Kleinwort Benson’s process is more systematic; the investible global universe is divided into regional industry buckets with the highest yielding / financially robust stocks selected in each. The resulting portfolio of 200 – 300 stocks will be much closer to regional and sector neutrality compared to the market cap index.

As a result of the difference in approach, Kempen has been materially underweight to US equities since inception of the mandate (even more so than the MSCI High Dividend Index), while Kleinwort has been broadly neutral in US equities.

Both managers carry a value bias in their portfolios although this is stronger for the Kempen portfolio. Kempen carries a bias to smaller cap equities, a natural function of an equally weighted portfolio, whereas Kleinwort is more size neutral.

The performance of both managers has been disappointing when compared with a standard cap weighted index. However, compared with the MSCI High Dividend Index, Kempen is just about in line after fees and Kleinwort has added value. Over the first 2 years Kleinwort fared materially better than Kempen, even outperforming the cap weighted index, but a very poor Q1 2015 when a surge in growth stocks hit relative performance surprisingly hard has pegged back longer term returns. In contrast Kempen has proved more resilient in 2015.

Our formal ratings on the managers are Kleinwort Benson: ‘5’ – Preferred manager and Kempen: ‘4’ – Retain. Considered in isolation our inclination would be to retain both managers as performance is broadly respectable within the context of global equity income investing in the current market climate.

Over the medium-term there are grounds for expecting the excess performance of US equities to abate and for there to be at least some element of mean reversion to provide some relief for value tilted portfolios.

If there is a structural factor to take into consideration, such as the inclusion of a quality growth manager to provide more balance to the overall equity portfolio, then we would retain Kleinwort Benson in preference to Kempen in line with our higher level of confidence in the former as reflected in our ratings. On balance we consider Kleinwort’s process to be the more stable as well as delivering lower volatility whereas Kempen’s stock selection has lacked innovation, remaining rather more heavily reliant on dividend stalwarts such as Telecoms and Utilities than we would ideally like to see.

Fundamental indexation (RAFI) allocation

At present, c.20% of the equity portfolio is invested in regional fundamental indexation (RAFI) mandates; c. 1/3 in Europe, and 2/3 in North America. This approach allowed the introduction of an allocation to fundamental indexation while the Fund had the zero weight to Japanese equities. Given the decision last year to introduce a partial weighting to Japan and our recommendation in this paper to increase this to a full weighting, we believe it is appropriate to review this allocation.

A simple option would be to replace the two regional L&G RAFI allocations with the global, all-country L&G RAFI 3000 Index Fund. This would offer the following advantages:

- Fundamental indexation exposure would be diversified across all six main regions (UK, Europe ex-UK, North America, Asia ex-Japan, Japan, Global Emerging Markets) rather than just the two regions (Europe ex-UK and North America);
- The RAFI 3000 Fund will automatically adjust and rebalance the regional weights based on the underlying fundamentals and attractiveness of each region, as well as rebalancing the stock weightings within each region.

However, we note that the global RAFI index has a persistent underweight position in US stocks, and relative overweight to European stocks. Hence, moving to a global RAFI index would lead to a further relative bias away from the US in the overall equity portfolio, unless specific action was taken to offset this bias.

We also note that performance of the RAFI global index relative to global market cap has been poor when compared with the RAFI European and RAFI US indices.

Relative performance*	RAFI Global	RAFI Europe	RAFI North America
1 year	-3.8	-3.4	-0.6
Since inception	-0.3	0.8	0.7

*Performance is shown relative to the relevant Global/European/North American market-cap indices

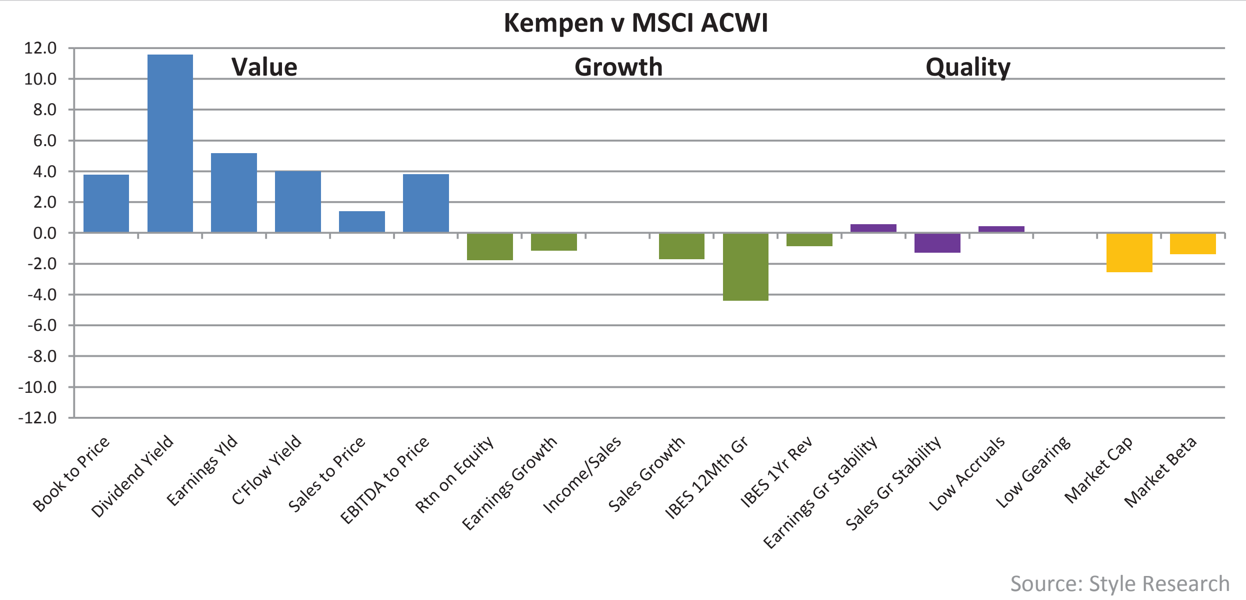
Finally, the change would potentially incur some transaction costs (although it would be reasonable to provide LGIM with a window to minimise costs by using their ability to cross investor flows between funds).

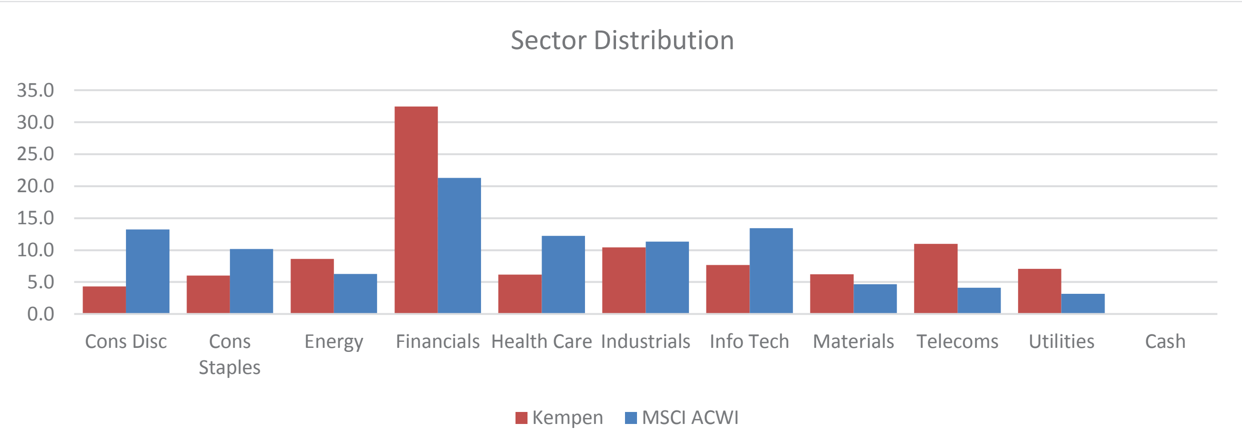
Hence, although with the reintroduction of a meaningful Japanese equity allocation the Fund could now move to a global RAFI 3000 Index for its fundamental indexation exposure, we see little compelling benefit or need to do so at this time.

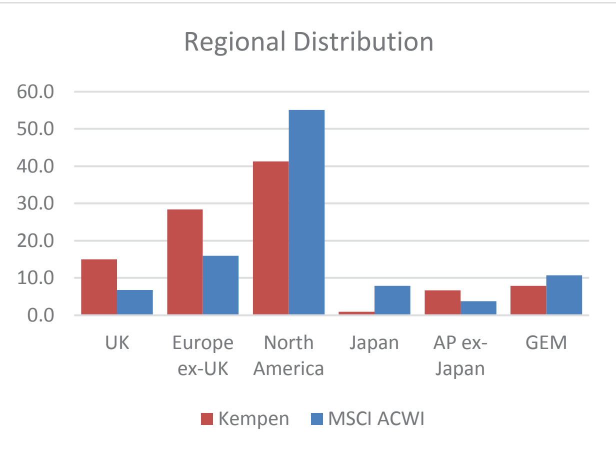
Appendix 2 Individual manager and RAFI analysis

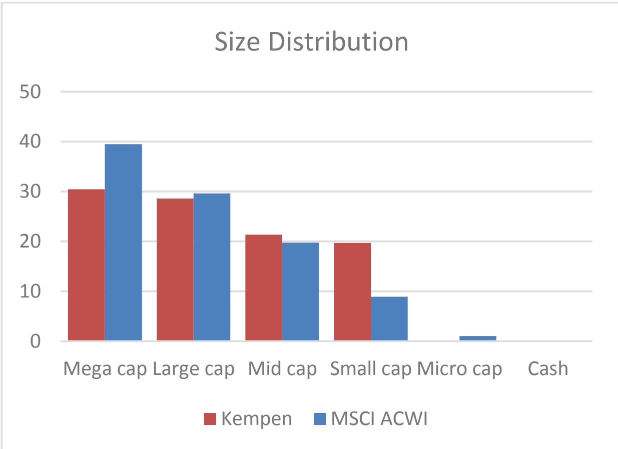
The charts below show the style, sector, region and style analysis for the individual active manager portfolios and the global, all-country RAFI index portfolio compared to the relevant global/emerging benchmarks.

Kempen

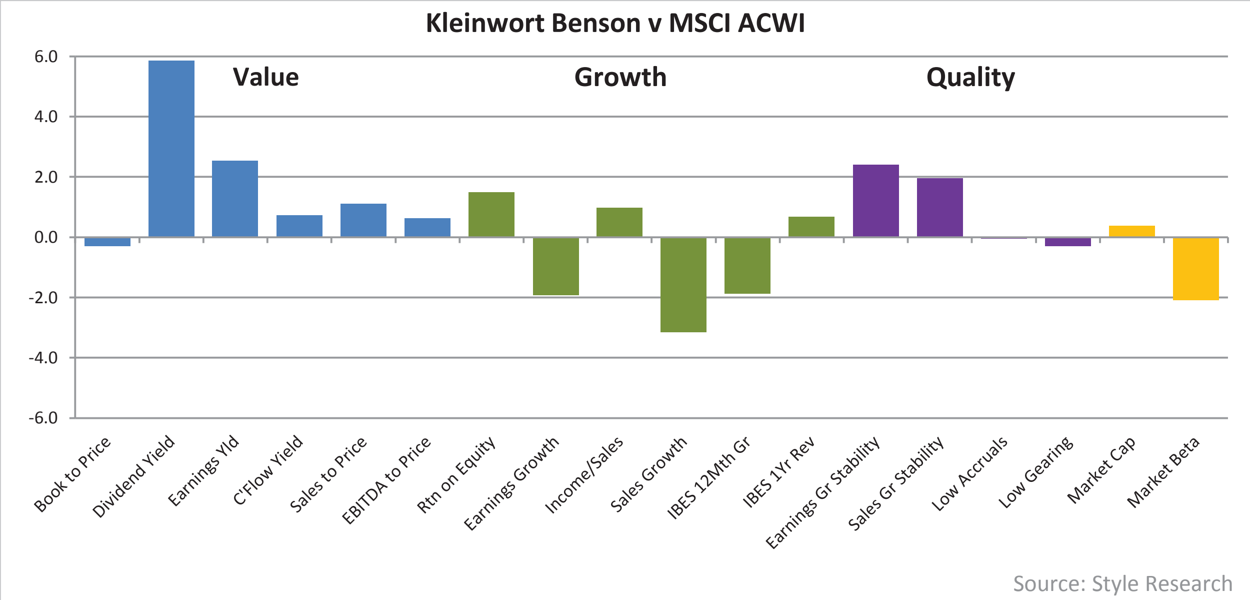


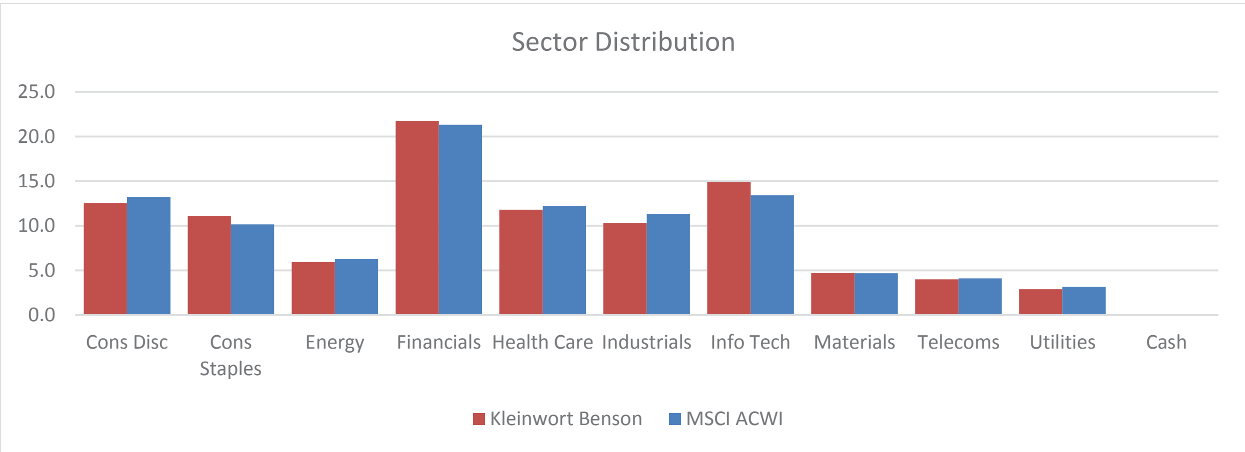


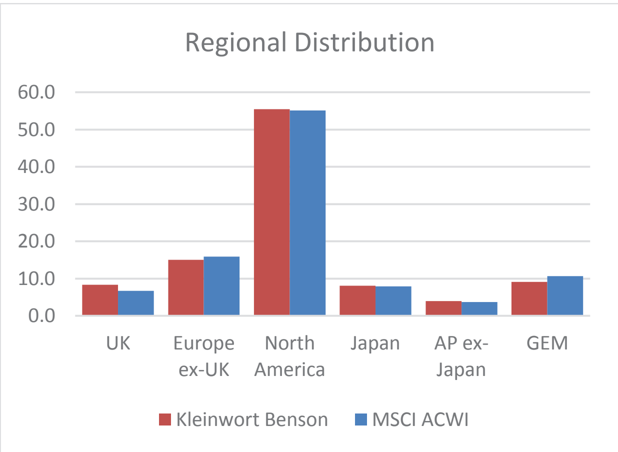


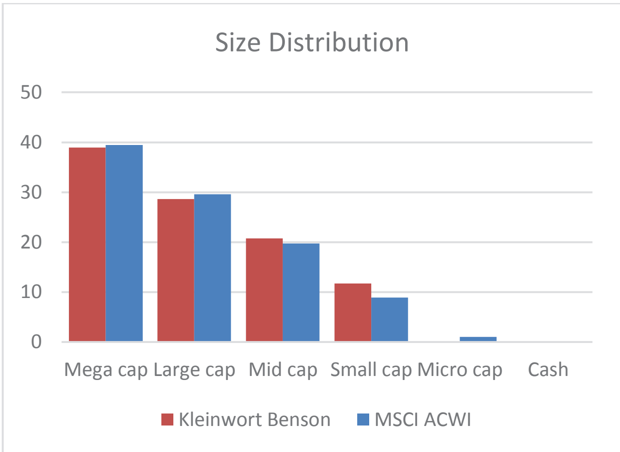


Kleinwort Benson

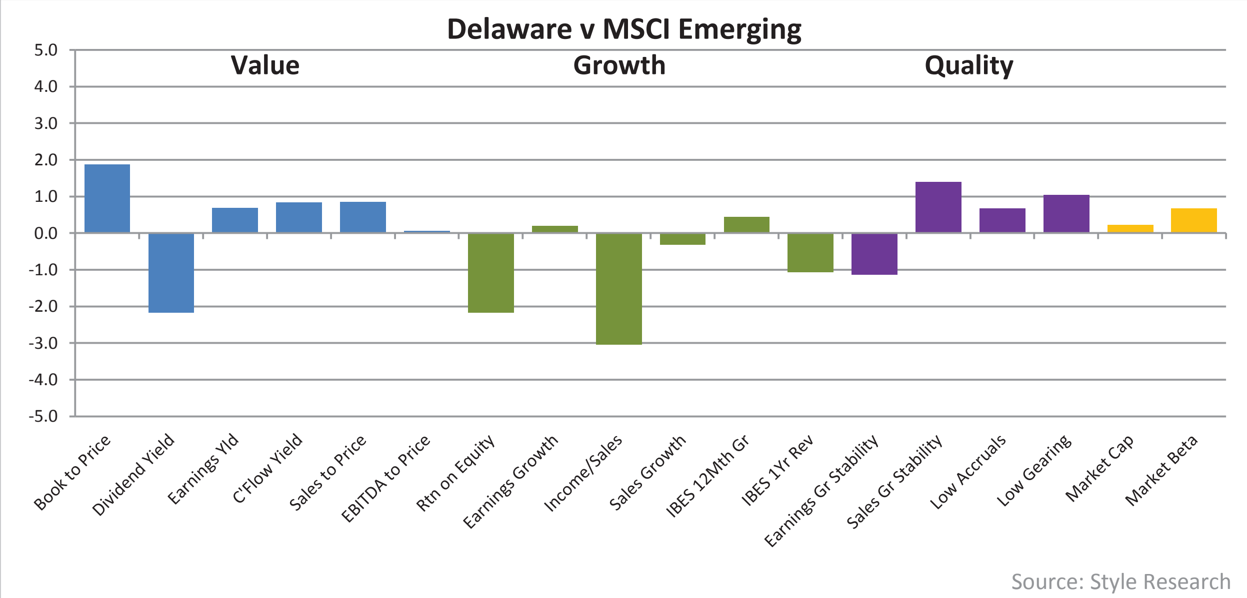


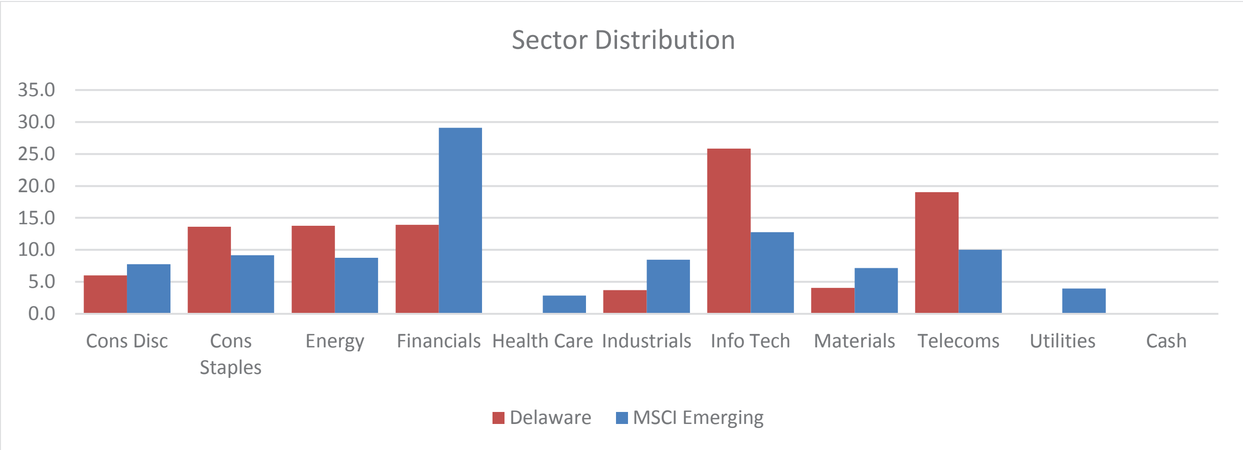


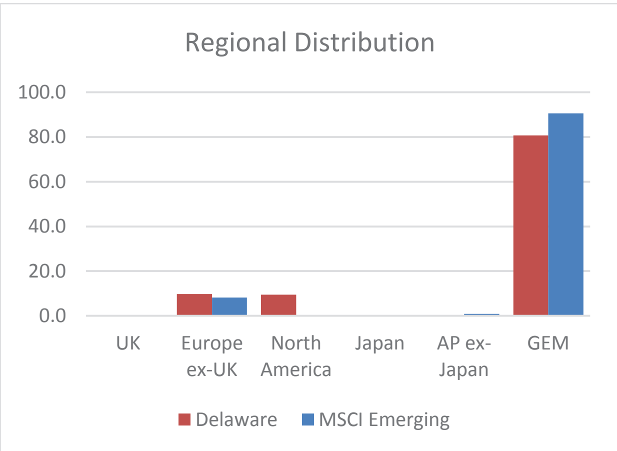


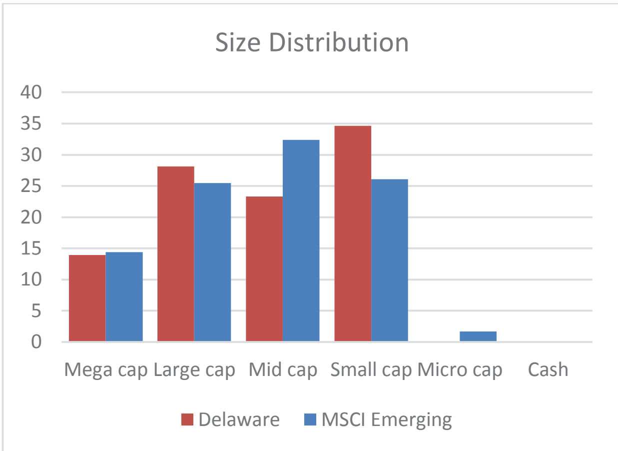


Delaware

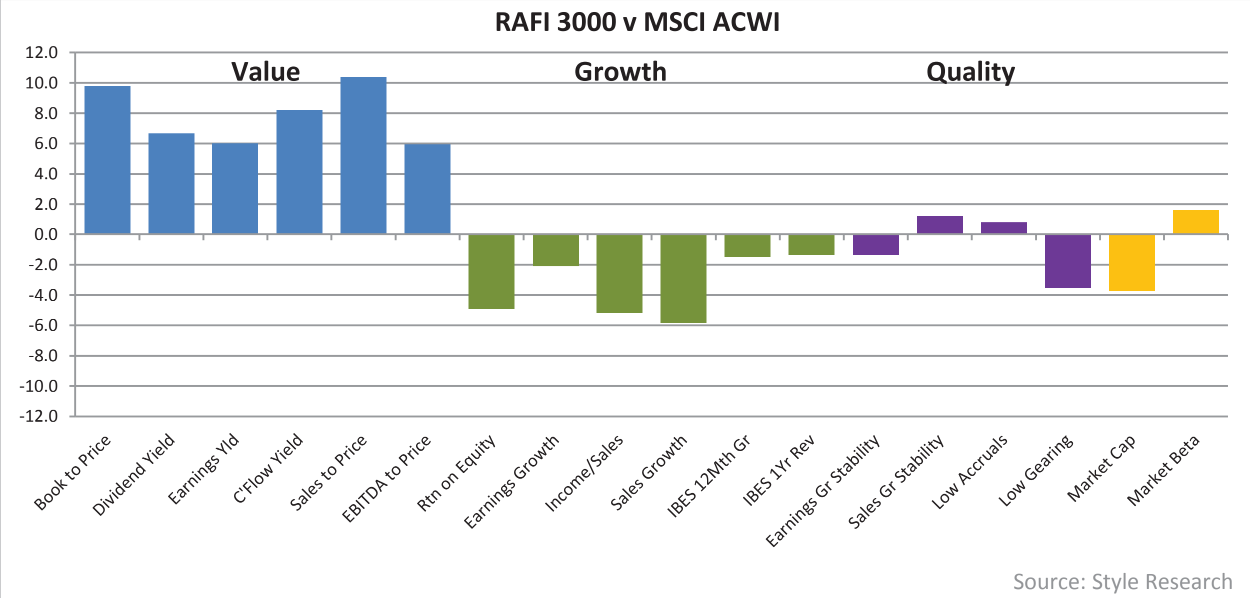

Delaware v MSCI Emerging
Value
Growth
Quality
5.0
4.0
3.0
2.0
1.0
0.0
-1.0
-2.0
-3.0
-4.0
-5.0
Book to Price
Dividend Yield
Earnings Yld
C'Flow Yield
Sales to Price
EBITDA to Price
Rtn on Equity
Earnings Growth
Income/Sales
Sales Growth
IBES 12Mth Gr
IBES 1Yr Rev
Earnings Gr Stability
Sales Gr Stability
Low Accruals
Low Gearing
Market Cap
Market Beta
Source: Style Research

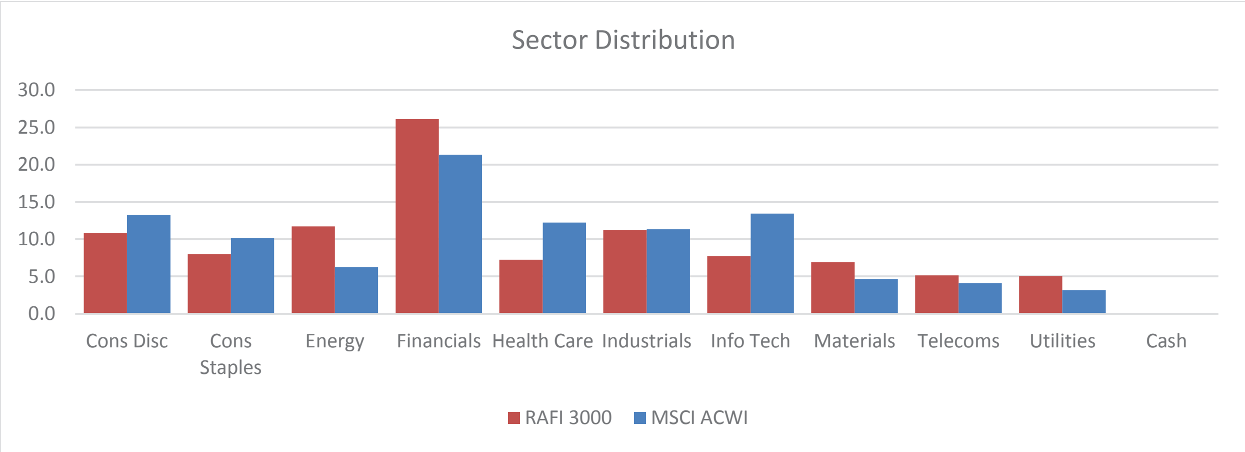

Sector Distribution
35.0
30.0
25.0
20.0
15.0
10.0
5.0
0.0
Cons Disc
Cons Staples
Energy
Financials
Health Care
Industrials
Info Tech
Materials
Telecoms
Utilities
Cash
Delaware
MSCI Emerging


Regional Distribution
100.0
80.0
60.0
40.0
20.0
0.0
UK
Europe ex-UK
North America
Japan
AP ex-Japan
GEM
Delaware
MSCI Emerging


Size Distribution
40
35
30
25
20
15
10
5
0
Mega cap
Large cap
Mid cap
Small cap
Micro cap
Cash
Delaware
MSCI Emerging

RAFI 3000


RAFI 3000 v MSCI ACWI
Value
Growth
Quality
12.0
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
-6.0
-8.0
-10.0
-12.0
Book to Price
Dividend Yield
Earnings Yld
C'Flow Yield
Sales to Price
EBITDA to Price
Rtn on Equity
Earnings Growth
Income/Sales
Sales Growth
IBES 12Mth Gr
IBES 1Yr Rev
Earnings Gr Stability
Sales Gr Stability
Low Accruals
Low Gearing
Market Cap
Market Beta
Source: Style Research


Sector Distribution
30.0
25.0
20.0
15.0
10.0
5.0
0.0
Cons Disc
Cons Staples
Energy
Financials
Health Care
Industrials
Info Tech
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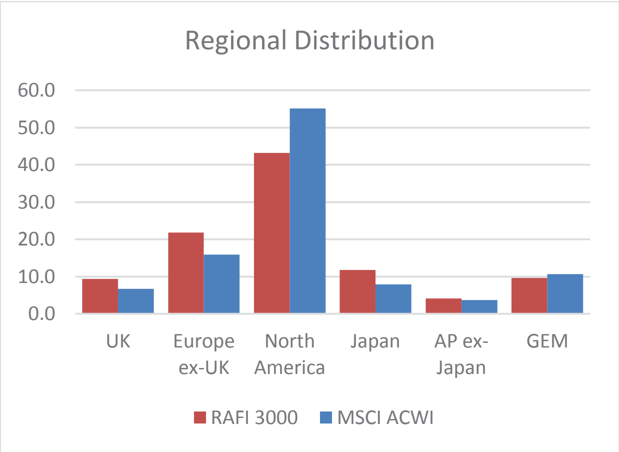
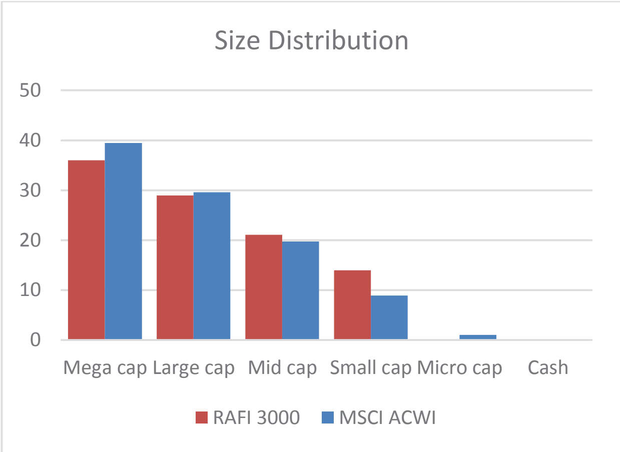
Telecoms
Utilities
Cash
RAFI 3000
MSCI ACWI


Regional Distribution
60.0
50.0
40.0
30.0
20.0
10.0
0.0
UK
Europe ex-UK
North America
Japan
AP ex-Japan
GEM
RAFI 3000
MSCI ACWI


Size Distribution
50
40
30
20
10
0
Mega cap
Large cap
Mid cap
Small cap
Micro cap
Cash
RAFI 3000
MSCI ACWI

Appendix 3 Property

Background

The Fund is currently very close to its 10% target allocation to property through its direct and indirect investments with Colliers and indirect investments managed by Aviva Investors. There is an additional 0.8% allocation to higher yielding properties through the Kames fund, which sits within the Fund's Opportunities Pool.

UK commercial property has been a core asset for UK pension funds for many years. Over recent years property mandates have evolved to cover a range of specific areas or sub-sectors of the property market to fulfil a variety of objectives. Each of these property sub-sectors offer the prospect of long-term investment returns, but with varying levels of certainty and security relative to the broader market.

The table below provides an overview of the core and sector specific forms of property mandate implemented by pension funds.

	Core	Secondary/ Higher yielding	Long Lease	Private Residential	Social Housing	Ground Rents	Global (Core)
Expected Return (vs IL gilts), net of fees	+2.5-3.5% p.a.	+3.0%-5.0% p.a.	+2.0-3.5% p.a.	+2.5-4.0% p.a.	+2.0-2.5% p.a.	+2.0-2.5% p.a.	+2.5-4.0% p.a.
Expected term of contractual income (1)	5-10 years	3-10 years	>20 years	c1 year	30-50 years	100+ years	3-10 years
Security of contractual income	Good (subject to ongoing health of tenants)	Can be weaker than broad market, or higher yield simply a reflection of a shorter lease or smaller lot size	Good to very good (subject to ongoing health of tenants)	Good (annual renewal of lease)	Very good (security improves over time)	Very good (investments are over-collateralised)	Good (subject to ongoing health of tenants)
Nature of increases in income	Either open market review or contractual fixed/inflation linked	Either open market review or contractual fixed/inflation linked	Typically contractual fixed/inflation linked (with caps/collars)	Open market review but implied inflation linkage	Contractual inflation linked (with caps/collars)	Contractual fixed/inflation linked (with caps/collars)	Dependent on jurisdiction
Key risks	Voids, Obsolescence	Voids, Obsolescence	Tenant default, residual value	Voids, Concentration, Reputation, Political	Political, Affordability	Management (for residential), Ability to build portfolios	Political, Currency, Voids
Liquidity if investment (2)	Moderate	Moderate	Good (given current demand)	Low	Negligible	Good (given current demand)	Low
Access to investing (3)	High	Variable; can take time for capital deployment	Reasonable (3-6 month delays on capital deployment)	Low (vehicles available, but underlying product is being built)	Low (deal dependent)	Very low (few vehicles with long queues)	Reasonable

Notes: (1) The expected contractual term of income represents the average length of leases within a portfolio. It should be noted that managers can intervene to extend the term of the income stream. (2) Liquidity refers to the ability to enter and exit the investment through either a primary or secondary market trade based on prevailing market conditions. (3) Accessibility refers to the prevailing ability to deploy capital into the strategy given both the availability of solutions and the capital currently allocated to the solutions.

The Fund has exposure to Core, a higher yielding element of core through Aviva and Kames, and a small allocation to residential and overseas property through the mandate with Aviva.

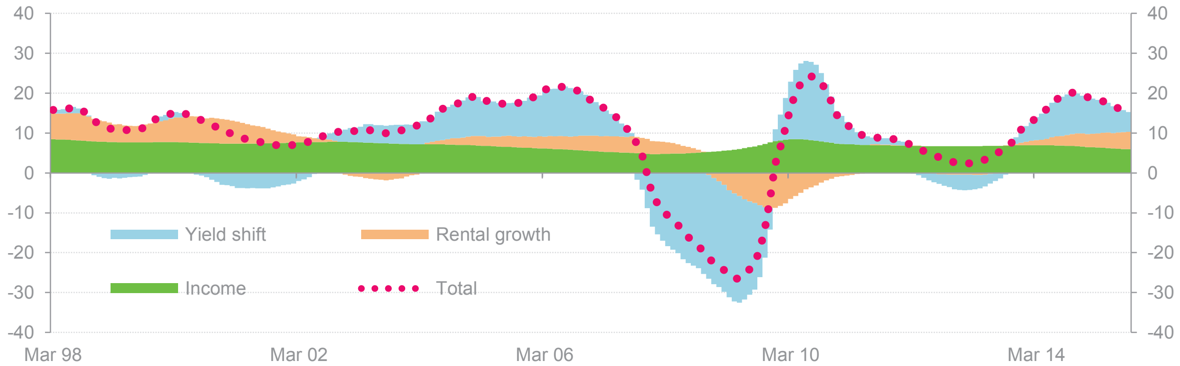
For the mainstay of UK pension fund property allocations, the rationale for the inclusion is typically to provide diversification away from equity and bond markets; to provide a partial hedge against inflation; and a return more focused on the underlying yield than the need for capital appreciation. Although property returns and risk profile have not always fulfilled this brief (2008 in particular), it has generally been effective at reducing overall risk within pension fund portfolios. Returns are primarily generated from rental income: over the long term, returns from UK commercial property have averaged c7% p.a. and the income component of total returns has been historically stable, between 5% and 6% p.a. This income security is supported by an average lease term of c10 years in the UK and the ability to re-let the property should an existing tenant default of their obligations.

Capital growth or underlying valuation is a far more volatile component of return, with both rental growth and yield shift experiencing negative periods of return (as illustrated in the first chart below).

The property market

UK property has delivered strong performance for the last 6 years following the c45% collapse in values around the time of the Global Financial Crisis. Since the trough in June 2009 capital values have risen by almost 40%.

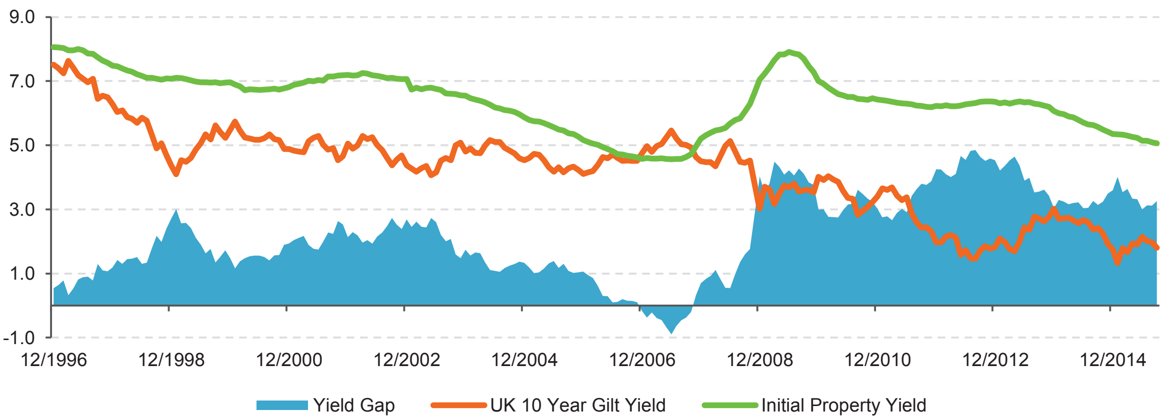
IPD Monthly Index – 12 month rolling returns (%)



Source: IPD, Hymans Robertson

The Net Initial Yield on the UK Monthly Index has continued to fall from c8% at the height of the financial crisis and now stands just above 5%, not far above the levels seen in 2006/7. However, values are still 22% off their 2007 peak and relative to gilt yields, the property market still offers a relatively attractive income gap as shown below.

Difference in yield between Gilts and Property



Source: IPD

A key question now is how resilient property values are to rising interest rates? This is likely to be sector specific and depend upon the geographical location of the property under consideration. Anecdotally, we note that yields on trophy assets in Central London have fallen below 3%.

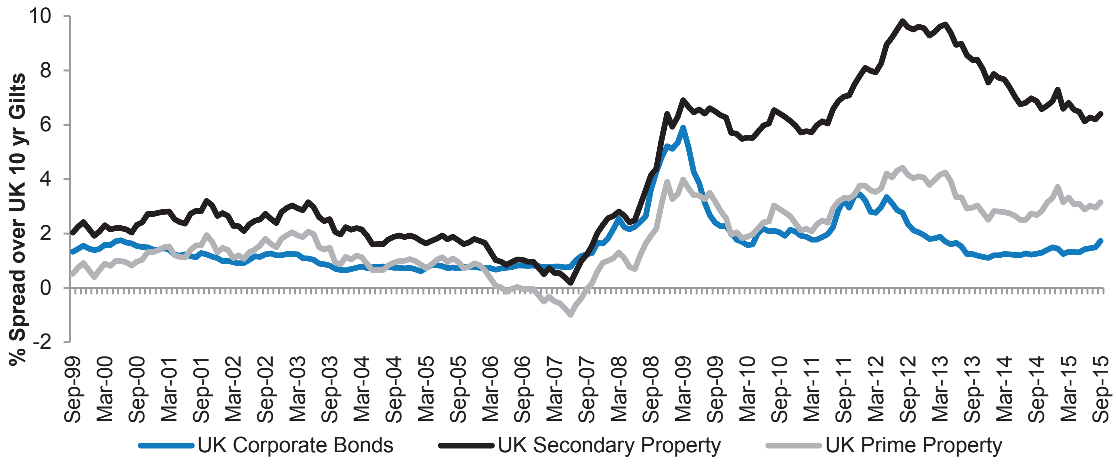
Data we receive from IPD (Investment Property Databank, now part of MSCI) suggests that some investors are already paying today for an element of expectation of future income growth that may or may not be realised. Whilst this may be justified in some areas, for example offices in London and the South East; it is clearly a risk to capital values.

Secondary or higher yield property

Property markets experienced a bifurcation following the financial crisis. Investors were initially attracted to the prime end of the market, lured by long-term, secure income streams. As a consequence, yields on prime assets remained close to their long term average whilst the yield on secondary quality assets increased substantially.

For the last 3 years or so yields have been falling, firstly on prime assets and followed by the best quality secondary properties as investors were attracted to this sub category by the exceptional yield differential. The chart below is similar to Chart 2 above but illustrates the divergence in yields according to quality of asset.

Yield spread on prime property, secondary property and corporate bonds relative to gilts



Source: CBRE, Bloomberg, FIL Limited

Secondary property is a wide term without a standard definition. Good quality secondary is generally an asset that falls short on one of the following: building quality, tenant covenant, least length and location. Unsurprisingly since location is the criterion that cannot be changed, it is generally treated as the most important. Some of what is included in the secondary data could be described as tertiary in quality and should be avoided by all but higher risk investors.

Although secondary yields have decreased substantially and some properties should perhaps be termed tertiary, the opportunity for good quality secondary properties is not necessarily over. The spread has narrowed but is arguably still attractive. The universe of secondary quality assets is large relative to prime assets, particularly when there has been limited new supply to the market.

The Fund appointed Kames in the first half of 2014 to exploit this opportunity, and Aviva also made commitments to its Recovery Fund I and Recovery Fund II.

Kames believe that the secondary market continues to offer a healthy supply of assets, particularly for properties in the £5m to £10m lot size range, where there is much less competition from other buyers.

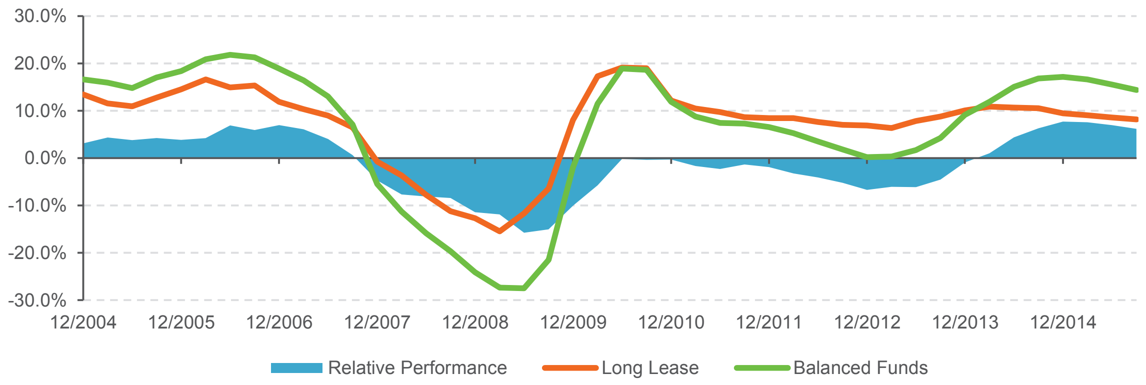
Aviva's Recovery Fund I is virtually fully repaid (it focused on the recovery of more prime property), and Aviva has received a bid for the whole of Recovery Fund II, which was launched to exploit mispricing on good quality secondary assets.

Long lease market

For the last 3 years the broader property market has outperformed the long-lease property segment driven as a consequence of both rental growth and yield shift (rising capital values). Rental growth across the property market has averaged 4.1% over the last 12 months, led by the office sector which has experienced rental growth of 8.5% over the year to 30 September 2015.

The long-lease sector is focused on contractual, often inflation-linked income streams. In an environment where inflation has been low, even when lease terms allow for a minimum level of increase, income has not been increasing as quickly.

Balanced Property Funds Index vs Long Lease Property Funds – rolling 12 month returns

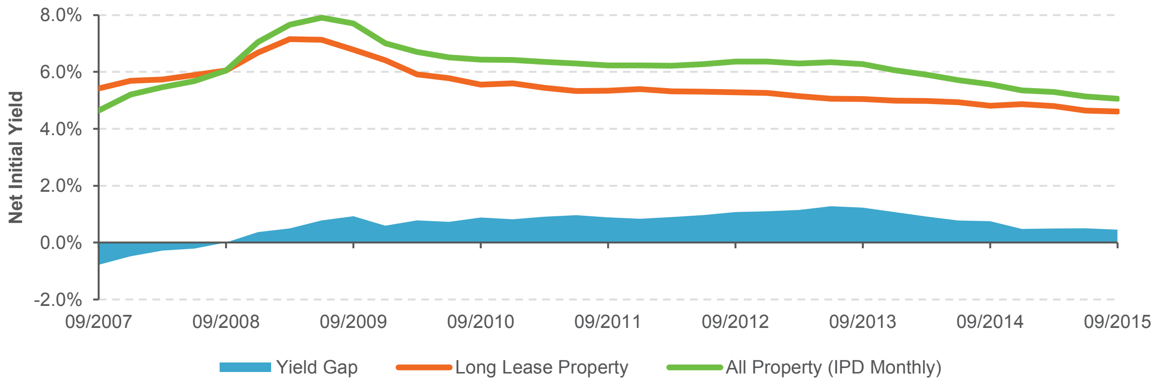


Source: IPD, Hymans Robertson

Over the long-term, we expect long lease property funds to be less volatile as illustrated above, and therefore investors can expect a lower yield than riskier core property funds.

Over the last c.3 years, the extra yield which core property offers has gradually been eroded as investors have paid up for the yield on core properties, and there have been some concerns with supermarkets, which comprise a significant proportion of many of the long lease funds.

Net Initial Yield on Long-Lease Property Funds vs All Property portfolios



Source: IPD, Hymans Robertson

For investors who believe that conventional property is now more than pricing in expectations of further rental growth, long lease property may be an attractive alternative or supplementary investment. We would add that although now more attractive on a relative basis, long lease properties are certainly not trading "cheaply".

Residential property

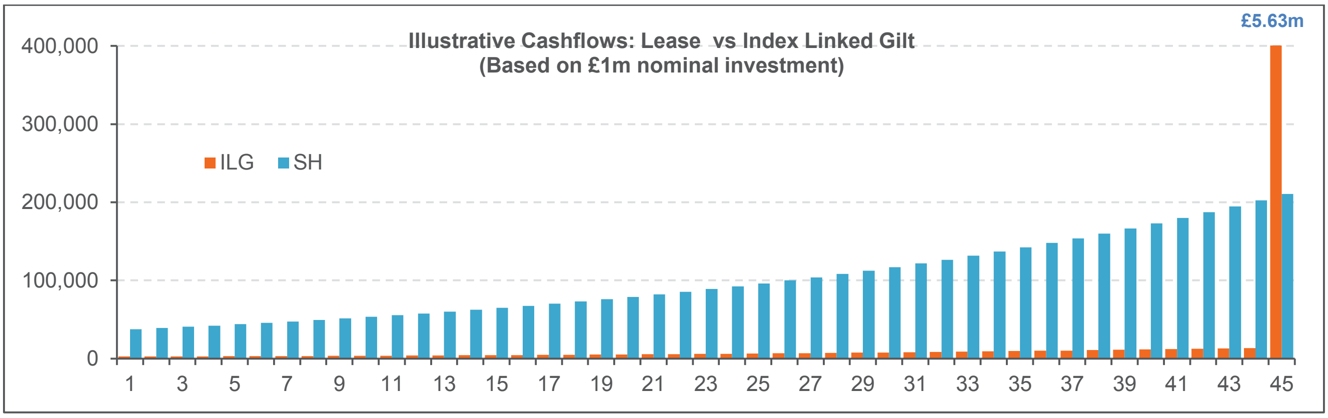
The UK has a chronic housing shortage due to lower numbers of houses having been built over many years and a rising population and increasing household formation. Residential property falls into social housing and the private rented sector. Demand for social housing is high; some 1.8 million households, equivalent to around 5 million people, are currently on the waiting list for such accommodation. The private rented sector has however been the fastest growing segment of the market. In order to meet the expected continued demand, it is estimated that around £200bn is needed to build 1.1 million new homes in the private rented sector over the next five years.

Social housing

Social housing is housing that is owned either by a local authority or a Registered Housing Provider, such as a Housing Association, and let to tenants at a rental level significantly below market levels based on the needs of the tenant. Whilst larger Housing Associations can and do raise finance through conventional debt markets, sale & leaseback is an alternative method of finance that has been used and can be attractive to pension schemes.

Under a Sale & Leaseback structure, investors gain exposure to an income stream secured against a portfolio of residential properties. This is typically an existing portfolio of assets, providing capital to the Housing Association (potentially to construct further properties).

Given the desire to retain ownership of the underlying properties and ensure that the properties remain social housing, the majority of investments typically include a de-minimis buy-back clause. This means that such investments are typically amortising in nature, offering a profile more consistent with pension scheme liabilities. The chart below compares the cashflows from a social housing (Sale & Leaseback) investment with those from an index-linked gilt.



Source: Hymans Robertson calculations. Assumes real yield on 45 year gilt of 0.25%; Assumes Net Initial Yield of 3.75% and RPI linkage in lease

The yield available on such investments will be dictated by levels of rent that can be charged to tenants. With rental income funded at least partially by housing benefit, future increases in lease payments need to reflect likely increases in housing benefit (which have been capped at CPI+1% p.a.).

Given both the regulation of Housing Associations and the increasing security associated with the investment as capital is gradually repaid over the lifetime of the investment, social housing is generally regarded as being very low risk. However, there is likely to be minimal liquidity associated with individual investments once made and investments are subject to political risk, such as changes to "right to buy".

Private Rented Sector (PRS) housing

In contrast to social housing, the private rental market is dominated by landlords with relatively few properties under management. Bringing scale to this market, from both an investment and management perspective, is an opportunity for investors to enter and "institutionalise" the sector.

The perception of residential property investment is that the income yield is generally lower than for commercial property. Evidence suggests that this assumption is correct although this is location dependent.

The evidence for rents increasing in line with inflation is reasonably strong. IPD data demonstrates that, over the 13 year period from 31/12/2000, rents rose by 2.6% p.a. compared to RPI increases of 3.0% p.a. Longer term evidence is available from overseas markets. For example, rental growth in Germany and the Netherlands, both of which have far greater levels of institutional investment in residential property, has exceeded CPI inflation by 1% p.a. and 1.2% p.a. respectively over the last 50 years.

Ground rents and Income Strips

It is easy to forget that there is more than one element to a property investment. Land can be owned independently of the buildings, with the landowner (or 'freeholder') owner granting a long (sometimes 100 years or longer) 'ground lease' to the property owners, in exchange for ground rent. The property owners can then let the buildings to a range of occupiers under a normal commercial lease. The long-leaseholder receives rent from the commercial occupiers, but pays ground rent to the freeholder. At the end of the ground-lease, ownership of the land and any buildings on the land reverts to the freeholder.

This structure provides significant security for the freeholder as:

- The level of the ground-rent is typically significantly less than the ongoing rent being paid under a commercial lease (often 10% or lower). In the event of default by the long-leaseholder, the freeholder can seek payments either from the occupiers, or if applicable, from any lender involved.
- The value of the ground lease is typically a fraction of the value of the buildings. In the event of default by the long-leaseholder, ownership of the buildings reverts to the freeholder and can be sold in the open market. As a result, long-leaseholders are heavily incentivised to continue to pay ground rents, even if the commercial property is currently vacant or they are under some sort of financial distress.

The protection or cushion provided by these factors means the risk of capital loss for the freeholder is minimal. As a result, ground rents have characteristics which are secure and bond-like in nature. Income strip assets, where the end value of the property reverts to the tenant, provide a similar return profile.

Ground rents and income strips may be fixed or increasing. Where increasing they may be capped and collared, similar to the long-lease property market.

This principal drawback of ground rent investment is the lack of supply and therefore difficulty gaining access. Moreover, the high security of the asset means that yields and expected returns are low, and more reflective of that which may be expected on investment grade bonds, meaning this type of investment may be attractive in a relative sense, but is unlikely to have a particular role to play for the Fund.

Appendix 4 Infrastructure

Background

The Fund has 3 existing infrastructure holdings: the IFM Global Infrastructure Fund and KKR Global Infrastructure Fund I and Fund II.

Infrastructure describes assets and services that societies require to function well. This definition will vary across geographies, but there are two basic categories of infrastructure assets: social and economic.

The former consists of social services such as schools, healthcare facilities and prisons, for which revenues are typically dependent solely on the facilities being maintained and available for use; revenues will have little or no reliance on how much or little the facilities are used, and therefore little correlation with the wider economic environment.

The latter consists of assets that support commerce, and for which revenues are typically dependent on fees charged direct to the consumer (demand based). Economic infrastructure can fall under the following sectors:

- **Transport Infrastructure** e.g. Bridges, Tunnels, Airports, Sea Ports, Rail and Mass Transport systems;
- **Communications Infrastructure** e.g. Cable Networks, Broadcast and Communication Towers, Satellite Systems;
- **Energy Infrastructure** e.g. Oil and Gas Pipelines, Power Generation, Gas Storage, Transmission and Distribution networks;
- **Environmental Infrastructure**, e.g. Water, Waste Treatment and Distribution, Waste and Recycling, Desalination Plants, Renewables.

Not all of these opportunities will present themselves in all geographies and, where they do, it is possible that they could have varying risk/return characteristics because of different regulatory or governance conditions. Typically managers quote expected net IRRs of 8-12% p.a. from investing equity in core infrastructure; we would consider high single-digits to be more realistic.

Financial characteristics

Although investment in infrastructure projects can be at different stages of the project, infrastructure projects have a number of distinct and typically common characteristics. In particular:

- Produce cashflows that are determined by a regulatory regime set by government, or sponsored by a government or quasi-government body;
- Are frequently monopolistic or quasi-monopolistic;
- Require a large initial capital outlay;
- Have to satisfy the double imperative of ensuring financial sustainability whilst meeting user needs and social objectives;
- Offer extended duration, stretching to 25 or 30 years and in some cases even longer;
- May provide inflation protection; the associated revenues are often combined with an inflation adjustment mechanism, whether via regulated income clauses, guaranteed yields, or other contractual guarantees;
- Provide stable and predictable long term cashflows that can support significant leverage;
- Provide a return that is predictable, inelastic and relatively uncorrelated with the business cycle.

Financing structures

Given these characteristics, there are two financing structures available to investors: debt and equity.

- **Debt:** Most infrastructure projects can be highly geared and sub-divided into 70-90% debt and 10-30% equity financing, depending on the project. The debt financing is generally:
  - Investment grade;
  - Secured on physical assets or contracts;
  - Issued by states, municipalities, utility companies, other large companies and banks; and
  - Can offers returns that may be linked to inflation and/or to project revenue.
- **Equity:** Exposure to equity can be via direct investment in listed and unlisted companies, and via unlisted (private equity like) funds and listed infrastructure funds.

Investment of pension fund assets in infrastructure debt is conceptually attractive – it is a socially responsible and constructive use of capital for economies, and should enable pension funds to earn a low risk return. However, in practice, with the exception of Network Rail, the actual level of debt made available to invest in state backed projects has been relatively limited, and in the past was quickly absorbed by insurance companies before pension funds even got chance to invest in it. As a result, pension funds have typically gained access to the debt of listed infrastructure related companies such as utilities and telecommunications debt as part of broader corporate bond mandates and specific allocations to infrastructure have been via equity.

The illiquidity of the equity-financed portion of infrastructure projects is one of the major constraints on pension fund involvement, especially for smaller pension funds, leading to some listed equity vehicles in addition to the unlisted equity funds. The valuation premium paid for the secure income stream from infrastructure equity in a low yielding environment, coupled with limited supply, has also led to the risk of investors potentially over-paying.

Risk and return characteristics

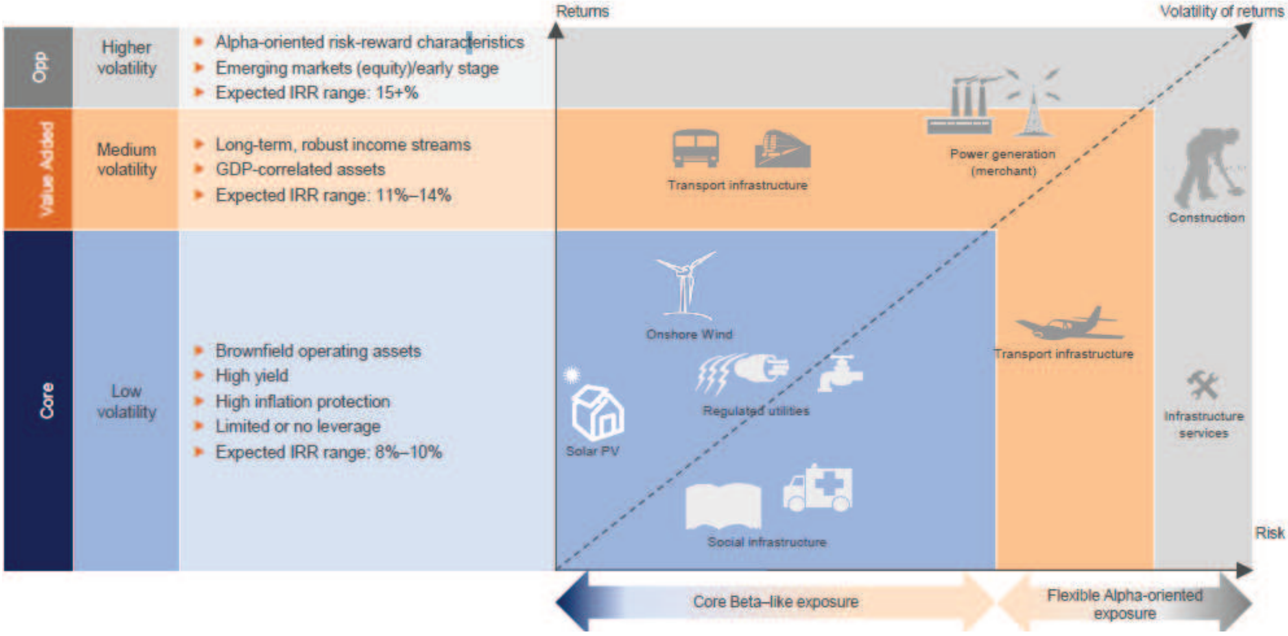
There are two popular ways to differentiate between higher risk and lower risk infrastructure assets. Traditionally risk has been defined by the stage in an asset's life – brownfield or greenfield.

Brownfield describes operations that are already up and running; therefore risk and expected returns is lower. Greenfield investments sit at the other end of the spectrum with risk and expected return higher for completely new projects.

The investment profile of a typical brownfield project is often described as similar to that of a long-term bond, with an immediate and sustainable income stream and a term of 20 years or more, and much of the overall return driven by current income. In contrast, greenfield infrastructure should correctly be characterised as being akin to private equity in terms of its risk and return expectations.

Pension funds are naturally more attracted to brownfield assets that already generate an income. However, if income is not required in the short term, accessing assets at an earlier stage could provide better risk adjusted returns as there tends to be high competition for brownfield assets, particularly in the current low yield environment, when traditional core brownfield asset prices have been bid up given the secure income stream.

Schematic of risk and return characteristics



Source: Hermes GPE

Perhaps a better way to differentiate between brownfield assets is to look at the surety and security of the income payments by differentiating between availability-based or demand-based infrastructure assets.

- availability-based assets generate income by making a service available (no matter how much that service is used); whilst
- demand-based assets generate income based on how much the asset is used.

Availability based assets are often subject to regulatory review. This is particularly true in sectors that used to be owned by the State and are now in private hands, such as water and utilities. Regulations effectively cap the returns that can be generated from assets whilst encouraging owners to manage the assets as efficiently as possible.

Infrastructure investing

Taken as a whole, LGPS has approximately 1% of total assets invested in infrastructure. However, the average is low since so many pension funds still have no exposure to the asset class and a higher allocation of c5% is not uncommon for individual funds.

Australian and Canadian pension funds, who were amongst the first institutional investors in infrastructure, allocate an average of 5% to the asset class. Their average is also driven by typically larger allocations from the biggest pension funds, whilst about two-thirds of Australian pension funds still have no infrastructure exposure.

Market opportunities

Core infrastructure assets can offer a decent cash yield of c4-6% p.a. and therefore are highly sought after and rarely trade cheap. The sheer weight of money chasing operational assets makes it tough to find attractive deals through auction processes.

That said, we believe good fund managers continue to find attractive deals in pockets of the market, working directly with potential sellers to avoid competitive processes in order to achieve higher yields.

There are a number of market dynamics underpinning deal flow:

- Lack of bank financing in smaller scale projects where it is inefficient for banks to syndicate out loans;
- Unbundling of supply chain from energy giants to increase European energy market competition; and
- The need of Governments and corporates to release capital from non-core / operational assets in order to invest in new projects.

Within this market sector, there are a number of opportunities open to investors or managers that remain relatively attractive:

- Various managers we research suggest that small-mid market deals appear to be less competitive.
- Co-investment opportunities are frequently available, at a lower fund management cost, due to the sheer scale of deals.
- Bolt on acquisitions can be found at times, which often exclude other buyers and may therefore secure a higher initial yield.
- Adding value through improving existing infrastructure assets to sell on to competitive core buyers can generate higher returns. To do this, it is important to have a team in place that is experienced at driving additional value from operating assets.
- Restricted opportunities remain on the secondary market to buy into existing funds from sellers that need/want liquidity.

Fund allocation

The Fund's initial allocation of 3% provided a first step into infrastructure. The Fund is currently a little below this 3% target exposure.

The Fund' current allocation is structured to deliver a blend of diversified return sources, with an emphasis on long-term investment and an element of inflation linkage. The Fund has 3 existing infrastructure holdings: IFM Global Infrastructure and KKR Global Infrastructure Fund I and Fund II. IFM's fund is open-ended therefore further capital could be committed over time. KKR's funds are closed-ended and have already passed their "final close" and therefore no new capital can be committed. However, KKR do offer clients co-investment opportunities outwith their fund investments and this could certainly be an option for the Fund if it is to increase exposure to the asset class over time.

We propose that the PFMB now target a 5% allocation. An allocation of c5% would have more of an impact and the Fund can benefit from the additional illiquidity premium.

As a next step we recommend exploring scope for further investment in the IFM fund and co-investment options with KKR, and perhaps investigating one or two new open-ended funds that would fit with the Fund's existing arrangements (see below).

However, as infrastructure investing is a key pillar of the Government's targeted outcomes we expect the landscape for LGPS infrastructure investing to continue to evolve. The Fund could eventually be compelled to pool infrastructure assets with other local authorities and the LPC will need to decide whether to allocate to existing funds or wait for a clearer picture on how infrastructure offerings develop in the post reform environment.

We provide below some comment on alternative options available to the Fund to increase the infrastructure allocation:

1. Allocate more capital to **IFM**;

   Core assets and in particular those large enough to be targeted by Sovereign Wealth Funds and other large infrastructure investors have been trading at keen yields for some time now. IFM has the advantage of having existing assets in place that may present unique opportunities to them through bolt-on acquisitions or large capital expenditure programmes. The team will not be purchasing assets if they do not believe the 8% hurdle return can be achieved. Cash yield has been 4.5% since inception but reduced to 2.8% in the last year due to large capital expenditure on new assets within the fund, in particular significant investment in Indiana Toll Road and Freeport LNG (a construction asset).

2. Increase exposure gradually through **co-investment opportunities brought to the Fund by KKR**;

   These will likely come along sporadically, but could provide the opportunity to achieve further investment in assets to which the Fund is already gaining access via the KKR funds. For each co-investment KKR will launch a separate limited partnership into which investors wishing to co-invest will commit. It could be considered as part of the "other opportunities" allocation rather than as part of the core infrastructure allocation. Timescales may well be short when opportunities are presented, and this approach may need additional governance or an amendment to the KKR mandate.

3. Invest through pooling structures such as:

   - The **Pensions Infrastructure Platform** ("PIP")

     The PIP was set up to invest in infrastructure projects "by UK pension funds, for UK pension funds", at a low cost for all. It has already deployed around £250 million in UK PPP assets. The current opportunity available is a UK small scale Solar PV (Photovoltaics) fund that is being launched by the PIP with Aviva Investors. The PIP is also preparing to launch a PIP Multi Strategy Infrastructure Fund. A core UK infrastructure fund with a long term buy and hold strategy generating cash flows that are linked to inflation. The PIP is working on achieving FCA approval for this strategy. We are meeting with the PIP in January to discuss this new strategy.

   - Another pooling arrangement that may come out of the LGPS pooling consultation.

4. Commit to another infrastructure fund

   - Another open-ended fund, including for example funds offered by one of the Fund's existing managers:

     - **Aviva Investors** offers a similar strategy to the one it manages for the PIP on an open-ended basis through its REALM Infrastructure fund; initially investing in solar but has started to diversify into other infrastructure sectors. Aviva's infrastructure investments are fully amortising meaning there is no capital expected to be paid back at the end of the assets' lives – the strategy is completely income based (see Income Strips within property appendix). Unlike its PIP strategy, Aviva's open-ended fund will top up investments over time to maintain duration.

    - **JP Morgan** offers an open-ended fund with a similar number of underlying investments to the IFM fund but a higher ongoing yield closer to 6%. This fund targets mid-scale deals which are said to be less completive than the large scale deals targeted by IFM.
  - A closed-ended fund, either a new fund or one that is approaching the end of its life but has a continuation offering available.

Separately, we also note that renewables is a sector specific area that can provide interesting opportunities for the Fund to explore. Returns for renewables can be based entirely on income, which is both distributed and often linked to inflation in some way. In recent years we have met with parties who have been attempting to consolidate sectors/industries that have, in the past, been rather fragmented. This can create interesting opportunities for opportunistic buyers who are ready to take full advantage. We believe opportunities of this nature should be considered under the Fund's Opportunities Pool rather than under the core infrastructure allocation.

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