Appendix 2

DRAFT RESPONSE FROM AVON PENSION FUND
LGPS: Opportunities for collaboration, cost savings and efficiencies

Thank you for the opportunity to respond to the consultation, LGPS: Opportunities for collaboration, cost savings and efficiencies. Before we answer the questions set out in the consultation, we would like to make a few important comments directly related to this consultation.

1. The key to delivering good investment and administration performance and value for money is good governance through ensuring there are appropriate skills and expertise throughout the governance structure (across the committee, officers, advisors).
2. LPGS governance is currently being strengthened and the new arrangements should be allowed to bed in before further changes are made. Reform needs to promote best practice and not force change or dilute the superior performance of funds that are already delivering. The consultation suggests that all funds should be brought down to the "average" rather than bring all funds up to the highest level of performance and best practice.
3. There is no consideration of investment risk in the consultation. Each LGPS fund has an investment strategy linked to its funding strategy which is specifically structured to defray the cost of the pension liabilities over a long time frame and to maintain as stable as possible the pension costs for the employers. The investment objective will reflect the risk adjusted return required to meet the funding requirement, and will therefore reflect the level of risk that can be passed on to employers through their pension contributions.
4. We support the use of any initiatives including collective investment vehicles (CIVs) that help reduce costs and/or provide access to a wide range of investment opportunities. However, the use of such vehicles or initiatives should be at the discretion of each fund to ensure they invest efficiently and meet their investment and funding objectives. Centrally prescribed policy will not necessarily achieve this. Strategic investment decisions are not simply about asset allocation; they are about managing the strategic risks *relative to* the liabilities. Therefore any changes in regulations must ensure funds have the flexibility to implement strategies to efficiently manage these risks.
5. The use of passive management is not low risk as there are inherent risks of concentration, valuation bias for example and if adopted across all quoted assets could give rise to systemic risk across the funds. From a risk perspective mandatory use by all funds is not appropriate.
6. Active management when effectively applied can add value and enhance returns net of fees. In recent years there has been greater use of risk based strategies to manage liability risk but these strategies

can be more costly to implement due to their complexity. Funds need the flexibility to access such strategies either within or outside a CIV.

7. Reduced use of fund of funds for alternatives would reduce costs as it would eliminate a layer of fees. However, if these assets are collectively managed, there will need to be a robust governance structure in place to take on the management of these assets (including the selection, due diligence and monitoring of managers) to ensure there is not an increase in risk and potential reduction in returns if, as a result, there is restricted access to best in class managers. As a result, there will be additional management fees arising from managing such assets via a CIV.
8. There is no understanding of how responsible, sustainable or long term investing approaches as put forward by the Kay Review would be incorporated in these proposals. Passive investing requires even more rigorous corporate governance, environmental and social risk input. Greater passive investing will leave UK markets more exposed to decisions of short term investors whose actions are not so aligned with long term pension fund investors and expose all Pensions funds to the fragility of the economic cycle.
9. In the absence of more radical reform of the benefits structure then the most appropriate solution to managing the deficits is to tackle the main structural drivers, low bond yields and longevity. Changes to the benefits structure to manage improving longevity in 2008 and again in 2014 have had limited impact on reducing costs. Although the current very low bond yields reflect economic conditions, over a prolonged period there has been a structural impact arising from a lack of supply of long dated index linked gilts. Greater issuance of these bonds or a long dated "LGPS" bond could assist funds to better match their liability profile at an appropriate valuation level. There is a danger that solutions to tackle current pressures on deficits are introduced just as the interest rate cycle turns positive for pension funds; a 1% rise in bond yields, which is not inconceivable, would reduce the value of liabilities significantly and alleviate immediate cost pressures.

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.

This question focuses purely on economies of scale and savings but not investment returns and risk. We would contend that costs and savings cannot be looked at in isolation. A properly constructed investment strategy will have taken into account the potential returns from any investment net of fees as well as the volatility of those returns and no well governed fund would consider investment returns or risk or costs in isolation. As investment tools have developed, giving accessibility to less liquid asset classes and more complex strategies, funds have sought to reduce the volatility inherent in their strategy in order to manage their funding strategy (which is re-assessed every three years, thus the need to manage volatility of returns). However, strategies to reduce volatility often cost more to implement than those

investment strategies that merely give exposure to market beta. Therefore any analysis of pension fund returns and related costs is flawed if there is no analysis of managing investment risk and we contend that management of risk is as crucial an element of investment strategy as is returns and costs.

If the intention is purely to reduce investment costs then we would agree that the use of CIVs would deliver savings in terms of management fees assuming economies of scale were achieved. However, there is no evidence to demonstrate that this will improve underlying investment returns especially if funds are restricted as to how they structure their portfolios. In addition, there may be other initiatives that could reduce investment costs yet be simpler to implement. Such initiatives include the use of framework agreements for investment mandates which could reduce fees through national "bargaining" power or more innovative approaches to structuring fees to better align active management fees directly to performance. For example, passive-like annual fees plus a greater element of performance fees once a hurdle has been achieved, with an ultimate cap for the total fee payable.

In addition, there is a risk the savings stated in the consultation are overstated for a number of reasons:

- Not all quoted assets should be passively managed given the inherent risk of some indices/markets.

  Passively managed assets are exposed less obvious risks, namely concentration risk, valuation bias and credit/sovereign risk. The obvious examples are the dotcom bubble, size of the banking sector in the FTSE All Share ahead of the collapse in share prices in 2008/09 and the weight of BP at the time of the Gulf spill. Passively managed portfolios incurred significant capital losses as a result of these events. Actively managed portfolios had the ability to protect capital through active investment decisions. Using the BP oil spill example, BP was 7.1% of the FTSE All Share at the time of the disaster whereas our active UK manager had an exposure of 2.3%.

  Passive management of portfolios tend to use market cap weighted indices which have a valuation bias as they will allocate more capital to stocks that are more highly valued. This creates significant risks in times of market or sector valuation bubbles. Alternative indexation approaches such as risk factor weighting, fundamental weighting, equal weighting would have to be offered for those funds that wish to manage or avoid such risk.

  Although the Fund has passive mandates, investment decisions not to invest passively have been made where we think the resulting exposure would expose the Fund to undesirable sources of risk. For example, we do not manage our corporate bond or emerging market equity exposures passively. An index of corporate bond issuers will by default have its largest weights to companies that issue the most debt, and thus could be the less creditworthy and financially secure. In emerging markets large countries can dominate indices leaving investors highly exposed to economic failure or currency devaluations, recent devaluations in the Brazilian and South African currencies being pertinent examples. An

active manager has the opportunity to such risks in their investment decisions.

- To achieve such significant savings the choices within (each) CIV would have to be limited.

  The assumption underlying the analysis of the use of CIVs by Hymans Robertson (HR) is that all funds have the same return and risk criteria across their portfolios and thus mandates. This is not the case and the extent to which this would need to be accommodated within the CIV structure will determine the scale of savings to be achieved. The HR report does not clearly consider this aspect. A fund's investment structure will comprise a range of risk adjusted return portfolios of assets to deliver the required investment objective. Therefore if the range of risk adjusted return options offered within a CIV were limited, funds would find it more difficult to construct a portfolio to meet their investment objective.

- There is no consideration of responsible investing approaches and corporate governance activities:

  The issue of responsible investing has significant relevance for passive portfolios as the investors have no option but to invest in poorly governed companies. The CIV would have to provide funds with the ability to act responsibly but the degree to which this is currently implemented varies between funds. For example our fund has a specialist SRI UK equity mandate where the manager explicitly selects stocks using to SRI criteria in addition to traditional financial criteria. The cost of such a mandate is higher than an index or mainstream equity mandate as the manager will have dedicated resources in order to deliver the product. Therefore if funds wish to select managers that actively engage on Environmental, Social or Governance issues as an integral element of their sustainable or responsible investing approach this option would need to be provided within a CIV.

- It must be acknowledged that the suggested savings will not be equally shared amongst all LGPS funds with inevitable "cross-subsidy" to those that have smaller, more expensive, investment mandates.

The use of CIVs for alternative and unquoted assets is intuitively compelling given the scope to reduce fees from a higher base and CIVs could increase the ability for smaller funds to access such opportunities. However, individual funds will have differing investment objectives for their alternatives portfolio. For example, our hedge fund portfolio targets a lower risk and return objective as the portfolio is primarily a tool to reduce volatility rather than generate excess returns. Other funds may have a higher risk adjusted return target for their hedge fund allocation.

Experience from Australia, where IFM created a similar structure to manage the assets of pension funds collectively, demonstrates that the length of time to achieve savings in the alternative assets classes would be extremely long. Many alternative investments are through closed investment vehicles in which committed capital cannot be withdrawn before the end of the fund's term, and thus the transfer of assets will take time. This is not a reason not to use CIVs but just an acknowledgement of the time it will take for savings to materialise.

As mentioned previously a robust governance and operational structure must be established for alternative CIVs which will dilute some of the savings. The HR report assumes costs of 35bps if these assets are managed collectively but does not explain how feasible this would be to achieve.

Therefore we would contend that the investment arrangements of the CIVs will need to be flexible and provide a wide choice of investment options in terms of mandates in order to accommodate the requirements of the investment strategies across the local funds. CIVs could be established for standard passive and the more common active mandates, leaving funds to appoint managers outside a CIV for more specialist mandates. As a result choice will diminish the overall savings.

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

Yes. Administering authorities have responsibility and accountability to its local scheme employers to manage the risk and keep contributions affordable.

The LGPS is primarily funded by local authorities and other public sector employers located in a local area. Unless the way the LGPS is funded changes in a way that would alter accountability, the use of local public funds should be determined and controlled by those accountable. Each fund has its own membership profile and a locally agreed funding plan to fully fund the pension benefits accrued. The investment strategy must be consistent with this funding strategy for the funding objective to be achieved.

The key to achieving its investment objective is the governance arrangements of LGPS funds. This is being strengthened which should help build and maintain a knowledge level commensurate with making strategic investment decisions. Funds should be encouraged to strengthen committees with co-opted members to mitigate the risk of high turnover of elected councillors on committees.

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?

It is flawed to structure a CIV around asset classes as there are numerous potential risk/return profiles within an asset class. Instead investment mandates should be targeted if flexibility is to be provided for funds to efficiently structure their investments to meet their investment objective.

Another key consideration is the optimal size of an investment mandate, meaning the size at which the manager can still implement its strategy without increasing risk. This is obviously more of an issue for active and alternative mandates than passive. Maximum savings would be if one CIV was created with sub CIVs or structures for differing investment approaches/mandates. However, optimal mandate sizes may make regional CIVs or alternative structures more appropriate.

If the CIV option is introduced (either mandatory or voluntary), there may be a case for establishing CIVs for passive investing in quoted assets first as there will be greater commonality of existing mandates across the funds, thus there

may be greater buy-in. However, there are passive assets already managed in-house by some LGPS funds, often at a cheaper cost than external passive funds. The paper is unclear as to how these would “fit” within a CIV structure or as an alternative to CIVs. Delegated investment management is possible under the regulations and although FCA registration is not required it would provide assurance.

We would assume the CIV would be established along the lines of the London Council’s CIV project (given the amount of work already undertaken), with a series of sub-funds with manager selection undertaken by the CIV Board (representing the LGPS funds). There could be more than one sub-fund for each asset class where there are differing potential mandates. We would contend for reasons set out in Q1 it is difficult to include specialist mandates for quoted assets in a CIV. The following should be included in the CIV structure.

Passively managed quoted sub funds to cover

- UK equities
- Regional overseas equities
- Global equities
- UK fixed income government bonds
- UK indexed linked gilts

Actively Managed quoted sub funds to cover

- Unconstrained developed equities
- Emerging market equities
- Corporate bonds
- Overseas government bonds
- Emerging market debt
- High yield debt
- Equity income funds

The case for investing via CIVs for alternatives is more complex and requires far more consideration before a vehicle could be established. Operational as well as investment considerations will need to be interrogated to ensure an adequate level of investment risk, liquidity and diversification in the options for investment.

Co-investment is a different approach to managing alternative assets collectively which would eliminate FoF layer of fees but would require resources and governance to ensure adequate due diligence and monitoring of investment partners is undertaken.

Potential alternatives/unquoted CIV would require the following sub funds:

- Single strategy Hedge funds – options for specific strategies
- Multi strategy hedge funds platform – options for diversified exposure
- Diversified growth funds
- UK property
- Global property
- Private Equity
- Specialist debt/credit funds

- Infrastructure
- Social infrastructure/impact funds
- Liability Driven investment solutions

Other real asset funds, such as agriculture and forestry, should only be included if there are funds of an adequate size to accommodate allocations from across the LPGS participating funds.

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

The CIV would have to meet all regulatory, authorisation and tax requirements applicable to LGPS funds and regulations.

As the London Boroughs are establishing a UK based tax efficient vehicle, it would be sensible to assess how this works in practice and to contrast this with other models used internationally or in the corporate sector before determining the type of vehicle. The government via the Shadow Advisory Board should commission a full review of the options before proceeding

Although the structure of the proposed CIVs is uncertain it is assumed it will have sub funds for each mandate / strategy. Manager selection will be undertaken by the CIV (by the CIV Board or through their delegated power) and LGPS funds will invest in units in the sub funds.

The governance arrangements will be vital for the CIV structure to have credibility with the funds that invest via them. The operational management of the CIV(s) should be fully independent of the funds and those related to the funds to ensure there are no conflicts. Governance will have to be owned by the funds either as shareholders in the CIV or having a representative body. The governance structure will be responsible for determining that that CIV meets their requirements and this will include the power to appoint / remove the CIV operator / managers if there are performance or delivery issues.

Each LGPS fund would need to be an equal shareholder in the CIV and the Board would be elected by the shareholders. However, a national CIV with 89 potential "shareholders" could give rise to representation issues in that funds may have a significantly diluted relationship with the Board. There is a risk that the governance framework will be cumbersome requiring a lot of detailed oversight with the danger that the big issues and risks could get lost. Smaller CIVs, perhaps regionally based may be a better governance solution. It will be essential that a CIV Board has expert independent advisors, and should have independent board members as required on corporate boards to ensure no (group of) shareholders have undue influence.

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 below offers best value for taxpayers, Scheme members and employers?

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

We do not support this option for the following reasons:

- It could limit a funds ability to implement the investment strategy required to meet its funding objective. This could increase costs to the employers in the long run.
- Passive investing is not optimal or appropriate for all listed/quoted assets; there are inherent investment risks that can be managed through active management
- Active management can add value as demonstrated by our fund. Over the last 3 years the attribution from active management has been 0.8% p.a. (Source: WM Performance Services/ JLT Investment Consulting). In monetary terms this has delivered added value after fees of £18m in 2011/12, £17.7m in 2012/13 and £19.4m in 2013/14. This has been generated by various managers across UK equities, overseas equities and corporate bonds.
- The key to above average performance is strong, robust governance structure. Our fund has an investment sub-committee which focuses in detail on investment decisions and supports the committee on investment and funding strategies.

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

We do not support this option. How would an arbitrary allocation be set? Who would be accountable if the arbitrary set parameters led to inferior returns and higher employer contributions, central government? The central setting of percentages to be invested in a specific way could be detrimental to an overall investment strategy which must relate to local funding strategies and could force funds to trade unnecessarily to achieve an arbitrary target allocation.

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

We already do this implicitly as part of any review of our investment strategy. The allocation between active and passive is part of the decision making process: whether an investment objective can be achieved by investing passively or not is fundamental to implementing a strategy in an efficient way and in allocating the "risk budget" within the investment structure.

We are not against this proposal but have concerns as to how it would be monitored and it could unintentionally increase consultancy/advisory costs if funds needed "expert" advice to justify their position more regularly than at a strategic investment review. As long term investors we would not want to undertake full annual reviews of strategy merely to comply with this requirement.

In addition, "comply or explain" implies passive is the default approach but this could put pressure on funds to index assets after periods of underperformance whereas it may be preferable from a market cycle perspective to not index (and vice versa, it may be preferable to index after periods of active management outperformance).

(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

Prefer this proposal as we already do this as stated in (3) above. Our Statement of Investment Principles sets out the investment strategy and how it is implemented. This option would also allow structures and collaboration already being undertaken such as co-investment, use of frameworks and collective investment vehicles to develop rather than be forced. If there is evidence that they can provide realistic alternatives and reduce costs then there will be support from funds. In addition, it would give funds the opportunity to continue discussions on ways to reduce fees and to re-align active management fees with performance in order to realise savings without the need for forced or significant changes.