LOCAL GOVERNMENT PENSION SCHEME: OPPORTUNITIES FOR COLLABORATION, COST SAVINGS AND EFFICIENCES

General Remarks

The Surrey Pension Fund welcomes the publication of the Government's consultation on structural reform of the Local Government Pension Scheme (LGPS). We welcome the Government's recognition that a full scale merger of funds is not the way forward: the change process would have been long and a major distraction from the generation of good investment returns and the managing of deficits. We agree wholeheartedly with the Government's aim for the LGPS to remain sustainable and affordable for employers, taxpayers and members over the long term. However, years of work at Surrey in the creation of a well governed scheme with high achieving fund managers could be undone with the new passive investment proposals. A 'one size fits all' solution isn't compatible with a high performing fund, and any saving on fees would be more than lost in reduced performance, based on Surrey's consistent above benchmark investment returns. The Hymans report has an undue focus on the total investment management fees, when the returns made net of the costs is the important aspect. The research should have focused far less on the 'input' of fee costs and far more on the 'output' of net returns achieved and how to maintain those returns.

Good governance practice and replicating that good practice from well governed funds would have been much more helpful for the future performance of the overall LGPS than the narrow and simplistic focus on costs and fees. As things stand, the Surrey Fund is asked under the existing proposals to forgo an excellent investment performance record. The proposals threaten to destabilise our strong performance by re-routing us down the path of passive asset management and away from the active management that has delivered excellent returns. Surrey has a Fund that was 72.3% funded at the 2013 valuation. A year later in 2014, this has improved to 80%, partly achieved from the Fund's out-performance in actively managed growth assets. We do not think we should have to forego the future prospect of those gains at a time when public services and the taxpayers would benefit more than ever from it.

We would urge the Minister to recognise the high achievement of a number of well governed schemes, such as Surrey's, and to ensure that there remains sufficient flexibility under any changes not to impede high performance. The Hymans evidence, that the LGPS has not generally beaten the returns available from passive management, may work in aggregate. But we do not want to be pulled down to the 'average' level of a passive Common Investment Vehicle when we have excellent and sustained returns over a protracted period. We do not want to take an unnecessarily longer journey to achieve our objective of being 100% funded. Surrey's strong investment returns permit the option to consider how to ease the pressure on employer contributions at a time when the strain on funding for public services is severe. Without the flexibility to continue with our own proven record of good management, the result could be additional employer contributions and in consequence additional cuts in services or pressures for tax rises.

With a total £178bn invested amongst 89 individual Funds, the LGPS will encompass many different approaches. It is not entirely surprising that, when taken as a whole, LGPS Funds have performed broadly in line with the market, as Hymans reported. A random sample of the market may well turn out to show the underlying market average rate. However, we would make the point that the proposals should focus more on helping the less well governed Funds as, by definition, the stronger performers are already delivering good value for money. We must keep what is working well and spread the message to the other funds.

A greater focus on returns net of fees, rather than just the costs themselves, would be helpful for the improvement of the weaker performing funds and would have more validity than the blanket proposals of a CIV and potentially the use of passive funds for all. Measures tailored to the weaker performing funds, such as use of passive funds, or a stronger procurement process,
14 would help improve their performance without restricting the performance of the high achievers.

As it stands, we are very concerned that these proposals could amount to a dilution of the high achievers to the average. This is our major concern and this arises because the Hymans study and Government proposals include all LGPS Funds as one. There is no distinction between the well governed Funds with good returns and all the others. The proposals amount to seeking a generic fund, with average returns, when we know and can demonstrate that Surrey has consistently delivered more than that. Each Fund is in a different position in terms of its funding level and will have a greater or lesser appetite for risk. A centrally imposed solution will ignore all local circumstance. The investment strategy must therefore remain a decision taken by the local councillors, and not from the centre. Government can and should assist by providing a framework for collaboration, but should not compel collaboration or dictate how funds are to be invested.

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.

No. Whilst a CIV could achieve economies of scale and provide some opportunities to lower investment management fees, what we are concerned about is the net returns achieved. For the Surrey Fund, the pooling of assets would compromise our flexibility to employ our own choice of active manager. Given the proven track record of our active growth strategies in delivering above benchmark returns over the last ten years, there are significant reservations over such a proposal.

A CIV might be helpful, but it should be done under voluntary participation. If the CIV meant we could access the same investment managers as we currently employ, and who have benefitted the Fund with their excellent performance, but for lower fees, then we would consider participation. It may be that, given our size at around £2.8bn, we already have economies of scale and the savings would be marginal. Also, for the fee reductions, it is likely the Investment Manager would wish to have much simpler reporting mechanisms, perhaps reporting just to one single entity, which would weaken the accountability to the Surrey Fund.

One of the criteria we would certainly wish to apply to any CIV is that it provides for a strongly incentivised fee for better than average return. The Surrey Fund believes that this is essential to promoting the goal of strong performance. Clearly, this could not apply to a 'passive' only CIV, providing for market average returns. Above all, we wish to retain the maximum amount of local freedom which has delivered proven results to date.

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

Yes. This is essential. We are pleased to note the benefits of local decision making and discretion are recognised as a part of the proposals. It is vital to maintain all local discretions. Local decision makers are best placed to take decisions in the interests of their fund. We firmly oppose any form of compulsion around using a CIV or allocating assets into a passive only management set up.

As well as decision-making on asset allocation kept in-house, there is also a powerful case for the investment of assets managed internally. Surrey will monitor the possibility of introducing internal investment management over the long term.

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?

Central Government should set out the criteria of what a CIV is seeking to achieve. Based on the consultation paper, it appears to be little beyond minimising the input costs of fees that we regard as too simplistic. The use of a common investment vehicle should be on a voluntary basis and it should be left to local Administering Authorities who are interested to decide on the number of funds and the mechanics of its operation. This would set up a framework that would permit Administering Authorities to maximise collaboration, whilst retaining local control and oversight. Funds should not be compelled to participate. Those responsible and accountable in each Fund should be entrusted with deciding based on local circumstance. 14

We also have concerns over applying a CIV to alternative assets. The fund of fund approach, whilst it is more expensive in fees, adds an extra element of diversity and risk reduction. Government proposals may be seeking a reduction in fees at the cost of limiting diversity and increasing risk. Assets held within fund of funds can be held for many different reasons but they are an important extra dimension to the choices over asset allocation. They can be important stabilising assets held to counter the volatility of equities. Again, local choice should be the overriding principle. We believe that, as with listed assets, the overwhelming case is for a permissive framework of a CIV to be in place, with the decision up to each Fund.

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

While there is some detail in the Hymans report about different types of CIV, Government must set out the relative merits of the different types of CIV and the criteria being proposed to establish them, e.g., access to lower fees, any applicable stamp duty exemption, reduced procurement time and costs, etc. It is then up to the participating Administering Authorities to agree the best governance arrangement to suit their local circumstances.

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 offers best value for taxpayers, Scheme members and employers?

NB options are:

- ***Funds could be required to move all listed assets into passive management, in order to maximise the savings achieved by the Scheme.***
- ***Alternatively, funds could be required to invest a specified percentage of their listed assets passively; or to progressively increase their passive investments.***
- ***Fund authorities could be required to manage listed assets passively on a "comply or explain" basis.***
- ***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.***

We support the option of Funds considering the benefits of passively managed funds with freedom and choice for Funds to operate within passive funds. Whilst a saving on investment fees overall may be obtained by compulsion, in our case, there is evidence that this would come at the expense of individual fund investment performance. Economies on investment fees offered would be, for us, a false one. Fees are strongly linked to performance in the Surrey Fund, thus ensuring a corresponding benefit as fees rise, as those costs are more than offset by enhanced investment returns. This situation only holds where a Fund can choose to actively manage its assets. Different funds will also have different pressures and time horizons.

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The Surrey Fund has strong positive cash flows and is expected to be cash flow positive for many years. We can therefore afford to take a long term view of our investments and may wish to take more of a risk with the volatility of active management. It is up to each Fund to decide based on its own circumstances.

Surrey's two best performing active equity managers were appointed ten years ago. The net investment performance figures of each manager from inception to 30 June 2014 and the overall monetary amount of the out-performance are as follows:

	Benchmark	**Net of Fees Return**	**Sterling Monetary Amount Representing the Out-Performance**
Manager 1 (Global Equities)	121.3%	190.8%	£74.1m
Manager 2 (UK Equities)	122.4%	200.1%	£53.1m

It may be the case that the weaker performing funds can benefit from being averaged up to the performance level a passive management provides. But it is not the Government's role to insist or decide this across the LGPS. Any use of a common passive management vehicle should be because it can demonstrate its merits to those pension funds who wish to participate. More work on good governance, fee structure, investment strategies, risk reduction and manager selection would have been a far more beneficial study from Hymans than the one presented.

Surrey Pension Fund
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