GovToday: LGPS Reform 2015

Susan Martin speech: The right route forward on investment

Wednesday 18 March 2015

Good morning.

Exactly four months ago LPFA'S Deputy Chairman Sir Merrick Cockell spoke at the GovToday conference on the future of the LGPS.

Sir Merrick asked the question - will the chancellor use the autumn statement for announce structural change of the LGPS? As we know, he did not.

So, whilst Einstein said that insanity is doing the same thing over and over again expecting different results, I'd like to start today by asking: will the chancellor use today's budget to announce structural change in the LGPS?

For that matter, will it make much difference?

Recent reports show that the vast majority of LGPS funds see structural reform as a distraction from the real issues that are affordability and deficit reduction. Also 90% of those funds are confident they can successfully deal with their deficit.

Rather than waiting for government to tell us what to do, funds have taken it upon themselves to develop in the way they see best. And they are working in partnership with each other.

Innovative councils and administering authorities are thinking more strategically and creating their own opportunities. Local government pension funds and their local authorities are keen to reduce costs and increase returns in an effort to eliminate the joint scheme's £47bn deficit. Seeking an additional increase in local taxes to cover pension fund deficits is not an attractive option for any politician, local or national.

Local authorities were not set up to administer pension funds. Over time these funds have grown and operate in a much more complex and global world than their employers themselves. Increasingly smaller funds rely on external advice for all decisions whilst the larger funds combine internal and external expertise to ensure that the in-house resource has appropriate challenge and guidance. Now this is not surprising that in many instances the assets of the pension fund dwarf that of the local authority of which they are part.

Increasingly local government pension funds are looking to work together and to invest directly in alternatives, such as infrastructure and property including all types of housing, rather than simply public equities and financial instruments. Funds want to access these assets because their return profile more closely matches what pension funds seek; that is a greater return over a number of years.

Many of the large funds such as Lancashire are, more than ever, actively managing their assets, working with other pension funds on co-investments, identifying those areas where they do not wish to invest directly and carefully appointing and then closely monitoring their external fund managers. At LPFA we have the internal expertise, governance capability and resource to do this and have been doing so for many years. Many other funds in the LGPS do not.

This is a testament to the growing gap in asset and liability management sophistication of LGPS pension funds.

In order to operate in the pension fund world of today and to make these changes to secure greater returns in a more risk managed way, funds need scale and in-house expertise.

For many years the LPFA has employed dedicated in-house professionals to run the pension fund rather than rely purely upon external advisers, consultants or other internal staff whose responsibilities and time is committed to other activities within the local authorities, as is the case with many smaller LGPS funds.

The understanding gleaned from in-house management; including understanding what it costs to deliver services, means much more effective negotiations can be had with external managers.

At LPFA our chief investment officer operates as an integral part of LPFA'S executive committee working closely with the chief finance and risk officer, director of pensions and myself. We focus on understanding first our liabilities in full - from our members through to interest rate and inflation impacts, and the cash flow requirements. From here we identify the investment strategy which will enable us to meet these commitments.

We work closely with our board of non-executives who are experts in public service, audit, and asset and liability management. Our decisions are based on what is right for our members and employers. Our CIO leads on the development of the investment strategy and his team executes that strategy. Their performance and that of our external managers is monitored closely not only by our chief finance and risk officer, but also by our executive committee, our investment and risk committees and ultimately via our board.

The shadow LGPS board, pension funds and the media have quite rightly focused on the fees paid to fund managers and consultants with a figure of over a billion pounds across the whole LGPS quoted. However, identifying fees is not an easy process. Apart from set up fees there are performance fees and transactions fees to name but a few. It is more likely that the total expenditure on fees exceeds this £1bn. The railways pension scheme, a £20bn scheme, has spent some time transforming their investment business and whilst they had always performed well against the benchmark of other funds what became clear when they began the transformation process was that they were paying far more than they were aware of. I'm sure this is true of us in the LGPS.

So not only do we need to secure better returns in an ever changing world we need to reduce costs. As long term investors we can do so by seeking assets which give greater returns, holding assets for longer, investing more directly ourselves or with trusted partners. We believe other funds can do this too. For example, in December we announced a plan to pool our assets with Lancashire county pension fund to create a £10bn fund. Together we call this an asset and liability management partnership, or ALM.

When this is fully established it will see a pension services operation with sophisticated and expert in-house resources servicing both administering authorities, including commonly managed liabilities, however historic liabilities will be managed by the individual authority. It will also include a commonly managed, jointly invested pool of assets overseen by an FCA registered entity created by the two pension funds, and a member and employer administration function all supported by effective corporate resources.

ALM partnerships with access to multi-asset classes offer significant advantages to authorities, through economies of scale, access to high levels of expertise and expert management of assets and liabilities.

Pension funds cannot simply rely on contributions and volatile investment returns as benefit payments continue to increase. They need income-generating investments in order to meet their liabilities on time. Assets that produce higher yields at a time of ultra-low interest rates, sluggish growth and ongoing uncertainty are vital.

We believe that infrastructure gives us that opportunity. Infrastructure provides inflation protection and the scarcity of good quality assets and active management leads to capital appreciation. Equally important, it produces consistent, stable cash flows over a long time horizon.

With a detailed understanding of our liabilities and when they fall due, we are also able to seek an illiquidity premium safe in the knowledge that we are investing amounts that we do not need to access for some time.

It is with this in mind that we recently joined with greater Manchester pension fund to form a £500m special purpose vehicle for the specific purpose of investing in infrastructure.

The mandate is deliberately designed to provide flexibility in investments and as such there is no 'typical' investment. However, we are looking to invest in projects from road building, to commercial and mixed-use developments, or large scale regeneration works. Along with providing us with the right return for our stakeholders we are also meeting a greater societal need.

We very much anticipate that others will wish to join with us in these partnerships. However this is not the only show in town, it is not the only solution, but what is certain is that greater collaboration between funds is the way ahead.

As I touched on previously, larger funds have the size, brand and resources to attract more talent to work for them. The aggregation of funds into larger pools would facilitate access to higher quality staffing resources and result in greater investor sophistication. Local accountability would remain.

Radio 4's file on four report that fund managers were buying and selling equities more frequently than once a year is disturbing. As pension funds, we don't need to be chasing market movements to seek profit. As John Clancy mentioned in the report, returns fluctuated from 12 per cent to 3 per cent – but the fees stayed at 11 per cent.

We believe that companies with sustainable, above-average growth and returns, whose prospects are not reflected in their valuation, will outperform over the long run. Therefore, our investment philosophy is to invest in outstanding, high quality global large capitalised companies at attractive prices and hold them; not worry too greatly about market fluctuations.

We call this 'buy and hold'. It delivers savings through a low turnover of stocks, which reduces transaction related costs, while in-house portfolio management means savings on both base and performance fees.

I'm not advocating we do everything In-house, but for us to work in partnership with each other.

As I close let me take you back to the beginning. Will the chancellor use the budget this afternoon to announce reforms to the LGPS? That's a question that only the government can answer.

However, I sincerely hope that they have been taking note of what LGPS funds have been doing and how far we have come while they've been trying to decide.