Keynote speech: Berlin Infrastructure Summit

Tuesday 10 March 2015

[Speech text: 3,787 words ≈ 40 minutes]

Good morning,

I'd like to thank Infrastructure Investor for inviting me here to today to give the keynote speech.

For some time now I have been speaking to politicians, pension professionals and journalists about the attractiveness of investing in infrastructure.

For some it's a hard sell and for others it makes perfect sense. Either way, I'm sure I don't need to convince this audience of its attractiveness.

As the Deputy Chairman of the LPFA I represent just one of the 89 pension funds that make up the Local Government Pension Scheme; the LGPS.

With over 4.5 million members, it is one of the largest public sector pension schemes in the UK. It's nationwide and, as the name suggests, focuses predominantly on employees working in local government.

It's also a scheme facing huge challenges.

With total assets under management of approximately £180bn the scheme is one of the largest in the world. It also has the potential to hold its own against many sovereign wealth funds.

However, with liabilities of £227bn it faces deficits which are bigger than its corresponding assets.

And these liabilities continue to grow. Cash outflows are greater than inflows and there is no central route map back to solvency.

It is because of this the government has launched a review into structural reform. It is still unclear what form it will take and when.

One thing is clear, however. In order to solve the under-funding that is the blight of our public sector pension funds, LGPS Funds need to invest more widely and with more regard to the long-term.

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 since assets often include an inflation linkage. 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 able to seek a liquidity premium safe in the knowledge that we are investing amounts that we do not need to access for some time.

With the average age of an LGPS active member and pensioner in the scheme now 47 and 67 respectively, we are facing a future of young pensioners with increasingly long years in retirement.

At this very moment, the LPFA alone has 65 members over the age of 100. Our liabilities stretch far into the future. Indeed, some of our current members may well be receiving pensions in to the next century.

We need these long term investments.

Of course there are many schools of thought that believe infrastructure is too risky an asset class and funds should remain focussed on the more traditional gilts and bonds, funds of funds and passive investment.

You may even hear more about that today.

Pension funds cannot simply rely on contributions and sluggish investment returns as benefit payments continue to increase. They need income-generating investments in order to meet their liabilities on time.

Large infrastructure investments can produce yields of 7 or 8 percent, compared to the average 2 or 3 percent returns often achieved by investment in bonds or gilts.

So while I understand concerns about infrastructure possibly being risky for some, there is no surer way to watch deficits increase than to invest in an asset class that produces a return lower, or only just in line with, the inflation rate.

It is useful to look at international comparisons.

A recent survey of global defined benefit pension schemes suggested that more than 40% are interested in infrastructure investments.

The LGPS needs to learn from those pension funds that are leading the way.

Take Canada’s largest public pension funds for example. They manage around C$740bn between them.

Their investment strategy is geared heavily towards infrastructure and property, as opposed to publicly traded stocks and bonds.

They also act as ‘co-sponsors’ on bigger transactions with leading private equity firms. This allows them to have more control over their investment.

They are not just investing in projects, but making them happen. This is something that UK funds should do.

Some of the UK’s larger LGPS funds play in this field. For example, Greater Manchester Pension Fund’s Airport investment vehicle has proven to be a strong competitor.

However, when it needed a strong partner to work with to acquire London’s Stansted Airport two years ago, it had to approach an Australian fund for assistance.

And recently, the Lancashire County Pension Fund was named in the shortlist for the Government’s stake in Eurostar. While it wasn’t successful in the end – losing out to a Canadian pension fund I might add – its inclusion was positive news from our point of view.

However, what was telling and concerning was that initial media coverage in the UK expressed surprise that the Fund was competing in the first place. Stories focused on the county being better known for Lancashire hotpots (it’s a lamb stew topped with potatoes), cotton mills and Blackpool’s Pleasure Beach than investments.

Can you imagine the Ontario Teachers’ Pension Plan being referenced only in respect to maple syrup, Mounties and ice hockey? I think not.

The inference seems to be that such a fund would be out of its league with an investment of this nature. Let us be clear, this is actually one of the LGPS's larger funds, with a total fund to invest of £5 billion.

The fact that Lancashire County Pension Fund is going toe-to-toe with larger international funds on UK assets should be the norm, not an oddity.

It should be celebrated as a step in the right direction. Both for the infrastructure that it could finance and for the UK pensioners it provides a future for.

It has become clear that large sums of investment for UK infrastructure projects are being sought from abroad. UK infrastructure has been a haven for large foreign investment for some time.

Numerous airports, office buildings and public assets are owned or heavily invested in by foreign players.

It is with this in mind that late last year I wrote a Letter to the Editor of the Financial Times. Following the publication of this, I received the request to speak today.

In the letter I described my disappointment that the UK Prime Minister, David Cameron, had been actively courting international investment while ignoring a huge pool of existing capital sitting on the government's doorstep.

In the past six months alone we've seen the Qataris purchase London's premier business district – Canary Wharf.

A consortium of the Australian Macquarie Bank and Spanish Group Ferrovial added Southampton, Glasgow and Aberdeen airports to their growing list of assets.

And there are also reports that several Asian buyers are lining up a bid for telecoms giant, O2.

These are just a few of the headlines.

These international funds, like many others, see the returns and the quality of UK infrastructure investments. And this will continue.

Sadly, LGPS Funds were not invited to sit at this table.

But I can also see why.

The LGPS is not one fund but a collection of individual local authority pension schemes. Not only do we all have individual balance sheets, but we speak with multiple voices.

To put it simply, if a call was made tomorrow seeking to speak to the LGPS about a potential deal, I don't know who they could call (unless they wanted to make 89 calls) and we wouldn't be sure who to send to the meeting. Nor would we have access to the full scale of funds I outlined previously.

What we face in the LGPS now is the issue of how we can build economies of scale as well as act with one voice.

To compete we need change. While the investment and returns profile of infrastructure investing matches the requirements of pension funds, it is not easy for small pension funds to invest in this asset class.

Scale and expertise are required. Collective investment and collaboration between LGPS funds is needed to enable investment in meaningful assets, deal with deficits and speak as one.

This would produce Funds with the size and financial clout to be able to access larger infrastructure deals previously unavailable, and to attract more talent to work for them.

This is what any government review needs to achieve.

This is why the LPFA has been calling for ‘Superpools’ amongst the LGPS Funds.

Pooling would provide scale in terms of assets under management, which enables direct or club deals in infrastructure projects.

They have the opportunity to generate superior returns and save investment management costs.

Research by the Boston Consulting Group on the Canadian public pension plans, where 80% of assets are managed internally, shows that fund management costs average 0.30% compared to 1.50%-2.50% for many other funds.

Now before some of you in the audience light the torches and sharpen the pitch forks on this point, I must add that I'm not advocating – and don't believe for that matter – that this will see wholesale change in how we deal with fund managers.

The provision for both in-house and external management is essential. 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.

The most effective funds seem to have scale to use in house resources, but supplement this with intelligent partnerships and co-investments with genuinely good external managers.

In addition, the extra capital freed up may give us the opportunity to possibly focus on further investment opportunities.

Larger Funds have the resources to pursue more complex liability driven investment strategies, focusing on matching future cash flows to future liabilities, hedging exposure to changes in interest rates and inflation, and offering significant additional flexibility and capital efficiency.

Looking at the LPFA Fund specifically: we invest through Funds, Secondaries and club deals. Investing direct, with support, is attractive as it lowers costs and gives control.

We look at direct and partnership investment in infrastructure and are seeking a mix of investments, including some development risks where returns are sufficient.

Other interesting areas that we have been looking at are alternative debts and property, especially in the Private Rented Sector. Both still present good investment opportunities.

PRS is a relatively new sector within real estate which we believe shows many characteristics which will be beneficial in helping us achieve our investment goals.

The private rented sector accounts for approximately 17% of all households, or nearly 3.8 million homes in England.

And with the well-documented shortage in the UK rental housing market, institutional investors like LGPS funds could play a significant development role.

We have begun to make small allocations to this space and as the sector develops we will continue to consider new opportunities.

Real estate can play an important part in pension funds' investments due to its potential for delivering inflation linked cash flow and growth over the long term.

This is not unusual for pension funds. For example, Hans de Ruiter, Chief Investment Officer of the Euro 2.6bn Dutch TNO Pension Plan recently said that, in a time of less stable cash flows, the income from real estate is the best match for the liability structure of their pension fund.

For a pension fund, this has the potential multi-benefit of providing high quality investment opportunities at the same time as providing a much wider societal benefit.

This is not a new concept. Institutional investment underpins the build-to-rent sector in several European countries and the United States.

This strategy, along with matching our assets and liabilities while managing our costs, assists us in our long-term goal of closing the funding gap and ensuring all our pensions will be paid as and when they fall due.

It also means we are, more than ever, actively managing our Fund and closely monitoring fund managers with whom we work.

However, we have the commitment and resource to do this. Many other funds in the LGPS do not. But without reform it is hard for them to do so.

It all comes back to scale and expertise.

For many years the LPFA has employed in-house investment professionals to run the pension fund rather than rely purely upon external advisers, consultants or pension fund accountants as is the case with many smaller LGPS funds.

At LPFA the Chief Investment Officer operates as a “manager of managers” responsible for developing investment strategy, liability management, selecting and appointing fund managers and monitoring their performance.

Many smaller funds claim that they are unable to afford the costs of a dedicated CIO role with appropriate levels of professional support.

This may go some way in explaining that the average number of fund managers used by an LGPS Fund is 9. Many have over 15.

This is not the best allocation of resource or time.

While I appreciate these do not relate to infrastructure investments, it demonstrates the level of investor sophistication of some Funds.

The ability to attract and retain in-house investment teams requires scale. It would not be possible to make such resources available to all 89 funds individually, and in any event the costs of doing so on a much smaller scale would be prohibitive.

The aggregation of funds into larger pools would facilitate access to higher quality staffing resources and result in greater investor sophistication.

Thankfully we are seeing movement. There is a quiet revolution taking place. Rather than waiting for Government to tell us what to do, Funds have taken it on themselves to develop in the way they see best.

Innovative councils and authorities are creating their own opportunities and thinking like investors.

Some of you may know, I have just been appointed Chairman-designate of the UK Municipal Bonds Agency. This is an exciting initiative which aims to reduce local authority reliance on cantralised Treasury funding, provide cheaper borrowing and in time facilitate inter local authority borrowing and access to European Investment Bank funds below their minimum loan size thresholds.

There are many parallels with what we now face in the LGPS. The Municipal Bonds Agency is own by local councils – an initial nearly 60 covering 30% of our population. By acting together and creating a municipal bond agency, local authorities will benefit from the economies of scale of large, liquid bond issues.

And by using our collective strength we will be able to borrow cheaper, reduce intermediary costs and create a new market in UK municipal bonds in the same way that has existed in, say Danish Municipal Bonds for many years.

This will help local authorities within current Prudential Borrowing codes to invest capital in local priorities, be they more housing or transport infrastructure; which in turn will benefit local communities. They will be truly ‘social impact bonds’.

By working together, local authorities can benefit from the scale and lower costs of municipal bonds. So too, by creating scale, the LGPS can benefit from the ability to access a wider range of infrastructure investments.

And increasingly LGPS pension funds are looking to work together and directly invest in infrastructure and housing, rather than simply equities and financial instruments.

I’ll use my own London Pensions Fund Authority as an example.

In December we announced a plan to pool our assets with Lancashire County Pension Fund to create a £10bn fund.

We call this an Asset and Liability Management Partnerships, or ALM. When finished it will see a commonly managed, jointly invested pool of assets overseen by an FCA registered entity created by the two pension funds.

It seems clear that if the LGPS long-term interests are to be met, other Funds need to do likewise and set up multi-asset, collective arrangements with strong internal management capabilities which best meet their investment needs and subsequent liabilities.

Such structures would maintain a framework of local accountability.

But without a clear understanding of what your liabilities are you cannot manage your assets to deliver appropriate cash at the correct time to pay your pensions liabilities.

These investment and liability management choices should be unconstrained within a prudential framework of course, supported by robust and appropriate governance.

There should be a requirement for Funds to clearly articulate the rationale for any investment and properly consider the risk-reward balance and cost effectiveness of that approach.

By adopting this methodology there is a high probability of achieving economies of scale, meaningful risk reduction and better governance when Funds with similar investment and liability management philosophies act together.

A fund’s investment returns must also be viewed in the context of the targeted period to recover full funding and the risk appetite of the fund’s stakeholders, both in the long term and with regard to maintaining stability of contribution rates.

These factors may vary considerably between funds so assessment of value for money must take account of the effectiveness with which a fund implements its particular strategy as well as the gross cost of doing so.

This is an opportunity for collaboration; not wholesale change.

So how does all this work?

An ALM Partnership model requires no additional legislation; simply voluntary collaboration and the formation of Joint Committees between funds, with clear lines of accountability to the partner Administering Authorities.

We have proposed that initial partnerships should be sought between Administering Authorities with similar investment philosophies that are willing to cooperate and agree on selecting and appointing a Joint Committee for asset allocation.

The partner Authorities would hold the Committee to account and would retain responsibility for member services and discretionary benefits decisions.

We expect this would naturally lead to partnership and shared services for member service administration.

Responsibility for setting contribution rates could remain with each Authority or be delegated to the Committee. This would achieve considerable governance and efficiency savings.

Reserved powers could be maintained through veto over some decisions, such as asset allocations felt to be significant or contentious, or the appointment of key executives in the ALM partnership.

We are not proposing a merger of liabilities. Each Authority would remain responsible for its own liabilities and those of its admitted and scheduled bodies.

The liabilities of each Authority would be tracked actuarially by the ALM partnership, just as most Authorities separate the liabilities of their admitted and scheduled bodies.

Such an approach would ensure that the participants in any pooled arrangement would be fully trained, fully qualified professionals.

The ALM Partnership would be the investment and governance hub of the arrangement. It would be formed by pooling suitably qualified personnel from the partner Authority and augmented as required by external recruitment.

Legal advice suggests FCA regulation may be required for the ALM partnership depending on the constitution of the Joint Committee and the level of delegation to officers. We view FCA regulation as a positive development, to support best practice and avoid any suggestion of ‘regulatory arbitrage’.

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.

In fact if Lancashire's bid for Eurostar had been successful then that asset would have been included in our ALM portfolio.

While these are early days, it is our desire to invite more funds to join this arrangement, and eventually build it to be a £40bn fund.

We see this as the beginning of what London's Mayor Boris Johnson has called a "UK Citizens' Wealth Fund" that can compete or partner with global sovereign wealth vehicles.

Whilst it is a competitive marketplace, we can offer the right projects a long term and committed partnership if they can offer us long term returns that match our needs.

Added to this, our local knowledge and relationships make us the perfect partners for many UK infrastructure projects.

In essence, LGPS Funds can offer the right projects a long-term and committed partnership in return for long-term returns that match our liabilities.

We are not alone in developing these alternatives. The 32 London Boroughs and the City of London have collaborated to form a Common Investment Vehicle.

They are doing so for the same reasons: To achieve economies of scale, significant cost savings and to improve access to alternative assets that may be beyond each individual Fund.

While the LPFA supports collective investment as a means to realising the many benefits of scale we caution against any change which would dilute the connection with the liabilities the investments are supposed to meet.

The liabilities I mentioned means that running a pension fund is not the same as asset management; a simple comparison of cost and return is insufficient to evaluate different proposals.

In planning and operating a solvent pension scheme, the timing and amounts of investment cash flows is of at least equal significance to annualised rates of return since the ultimate objective is meeting pension payments as they fall due. This is our first and foremost responsibility.

National, single-asset class CIVs also miss the opportunity to pool, develop and enhance the existing investment teams of LGPS administering authorities.

The economies gained between intelligent outsourcing and the development of internal capabilities changes with scale.

And there is also the Pensions Infrastructure Platform, which was launched in 2012.

I note with interest that following the coffee break this morning there is a panel session dealing with direct and indirect investments and the PIP.

While the LFPA were originally members of this platform, as it moved towards awarding its first mandate, it became clear that the pricing and risk-return profile it targeted differed from those we required.

It was with this in mind we explored, and have subsequently announced, a partnership with the Greater Manchester Pension Fund that fits better with our strategic direction.

The partnership will see the formation of a Special Purpose Vehicle into which each scheme will commit up to £250m for the specific purpose of investing in infrastructure.

This SPV will then make a variety of different investments over a three- to four-year investment period, with all drawdowns by the SPV being funded on a 50:50 basis between GMPF and LPFA.

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.

Amongst other things, we are looking at how we can become involved in funding projects linked to the development of the proposed HS2 high-speed rail lines between London, Birmingham, Leeds and Manchester.

We anticipate getting ‘money in the ground’ early during a full investment period of up to four years.

To be clear, both funds still remain free to compete separately and invest in other opportunities outside of this deal.

This is as yet another example of UK local authority schemes assembling together to make meaningful infrastructure investments.

We feel these moves are game changers.

For many, direct or co-investment in infrastructure is a long way off. But for others of us, we are making these moves now.

I have described the UK Local Government Pension Scheme as a sleeping giant failing to achieve its collective potential. This morning, I have described how we are now beginning to wake and see the potential that can come from collaborative scale focused on balancing our assets and liabilities and meeting our long term responsibilities.

Thank you.