RESPONSE TO CONSULTATION

Local Government Pension Scheme

Opportunities for collaboration, cost savings and efficiencies

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EXECUTIVE SUMMARY:

The Government has proposed a wholly passive approach to managing the Local Government Pension Scheme's listed assets. This is in response to the Scheme's lacklustre experience in active management, but misses an opportunity to address why the Scheme has failed to add value from active management. The Government risks throwing the baby out with the bathwater, forfeiting potential returns that could meaningfully contribute to repairing the Scheme's deficit.

Active management can add significant value. It has the potential to address the deficit in the Scheme to a much greater extent than simple cost minimization. The net cost savings from a switch to passive management constitute just 0.5% per annum of the deficit of £47 billion.[1] Achieving a total return from active management of 1% from the Scheme's listed assets would remove around 3% of the Scheme's deficit per annum.

Our experience is that this goal is achievable when investment insight is backed up by strong implementation. It is not enough to simply identify and appoint good investment managers. Effective implementation requires skill in portfolio structuring, product selection, tactical positioning and transactional efficiency.

The Government's proposals seek to exploit the Scheme's scale. Scale alone does not improve results, but it does increase purchasing power of professional expertise at a range of decision-making levels that could improve results. This is the real opportunity that lies in front of the Government. The Government should identify how it can use the Scheme's scale to upgrade its internal expertise as well as to capture cost efficiencies. The Government can position the Scheme to extract maximum value from its investments, and make a meaningful impact on the Scheme's deficit.

[1] LGPS Advisory Board, Fund Actuarial Valuations 2013

About Russell

Russell Investments is pleased to respond to the Government's consultation on the Local Government Pension Scheme. Russell Investments (Russell) is a global asset manager and one of only a few firms that offers actively managed multi-asset portfolios and services that include advice, investments and implementation. Russell has advised some of the largest institutional funds since 1969 and has provided asset management services since 1980.

Our Response

In summary, we submit that:

- To address the deficit, the Government must put value maximization ahead of cost minimization. Active management can add significant value. As well as the potential excess returns, active management can reduce volatility in multi-asset portfolios.
- The data confirms that the Scheme has not been successful in adding value from active management. However, the analysis does not identify why this might be the case. By not answering this question, the Government misses an opportunity to address the reasons for the failure of the Scheme's active management program.
- To succeed in active management, good investment insight must be backed up by strong implementation. Scale is not a sufficient condition for success. Strong governance is the required condition for strong implementation. We believe that governance challenges are the root cause of the Scheme's disappointing performance in active management.
- The Government should take this opportunity to consider how governance can be strengthened to position the Scheme for more successful investing, rather than prematurely capitulating to a wholly passive approach.

The Government is forfeiting potential future returns that could more meaningfully contribute to repairing the Scheme's deficit

Addressing the Deficit

Value maximization must come ahead of cost minimization

Cost minimization is the primary motivation behind the current proposals, but cost minimization alone is an ineffective approach to addressing the strategic issue of how to remove the deficit. The Government's proposals would reduce the deficit, all else being equal, by just 1% a year.

- Fee savings of £230 million from a wholly passive approach to listed assets are just 0.5% of the deficit.
- Fee savings from collectivising the alternative assets are also around 0.5% of the deficit.
- The potential savings from reducing transactional costs in the listed assets are unclear. The historical analysis of the Scheme's performance[2] indicates that in most listed asset categories the returns from active management have been sufficient to at least offset those transaction costs. As such, there may not be any net saving.

The Government needs to do more and to focus on extracting value from the Scheme's investment program as well as managing costs.

Active management can add significant value

The data confirms that the Scheme has, on average, been unsuccessful in extracting value from its active management of listed assets. The analysis does not identify why this is the case. The inferred conclusion is that active management of listed assets is futile. We strongly disagree.

Active management can add significant value when properly conceived and implemented. It has the potential to move the dial on the deficit to a much greater extent than simple cost minimisation. Achieving a total active management performance of 1% per annum net of fees across the entirety of the Scheme's listed assets would remove 3% of the deficit per annum.

[2] As set out in LGPS Structure Analysis, Hymans Robertson LLP, December 2013

Our experience is that this goal is achievable. Conditions for success are both investment insight (ie research) and excellence in execution. We discuss this further below. First, it is helpful to quantify the potential added value.

Excess returns

Active management includes dynamic asset allocation and positioning, portfolio structuring and product selection. Our research suggests that:

- even with modest success rates (around 60% success in product selection), portfolio structuring and product selection can add 0.5% per annum in fixed income and 1.5% per annum in listed equity[3].
- similar success rates in dynamic asset allocation can add 0.4% - 0.9% per annum depending on how large the tactical adjustments are allowed to be.[4]

For the Scheme's current listed assets, these sources could combine to achieve 1.7%-2.2% gross of fees per annum.

Volatility management

Added value can also come in the form of reduced volatility, particularly when dynamically managing the total portfolio. Volatility is costly:

- Volatility compounds over time to the detriment of return. Returns of -10% followed by +10% in the following year equate to a total return of -1%. The effect is smaller when the magnitude of the returns in either direction is smaller: -1% followed by +1% gives -0.01%.
- This effect is increased when cashflow is negative, as outflows following a period of poor returns crystallize the loss. As the Scheme matures, cashflows will likely become negative and this is already the case for a number of the regional funds within the Scheme.
- The implicit costs of management time in dealing with volatility and its consequences also merit consideration.

Accordingly, the added value from active management can come in the form of reducing volatility by adjusting the portfolio dynamically through market cycles. Heightened volatility since the financial crisis, along with the increasing maturity of the Scheme, make this an even more important source of potential added value.

Making active management succeed

Implementation matters

The gap between a good strategy and successful investing is execution. Securing value from your investment program requires good investment choices, backed up by strong implementation. On the assumption that the Scheme is well advised and generally uses high quality providers, we believe the failure of the Scheme's active management program lies here.

The Value Line Anomaly neatly illustrates this[5]. The recommended stock picks of a popular investment newsletter delivered superior returns over the market on paper. However, when those picks were put into a real portfolio requiring actual transactions to take place, the real portfolio underperformed the market. To extract the top line value, care must be taken in execution.

Just picking good asset managers is not sufficient. Effective implementation requires skill in portfolio structuring, product selection, tactical positioning and transactional efficiency. An exclusive focus on product selection not only fails to acknowledge the value of other sources of added value, but the resulting leakage may wipe out any advantage from strong product selection. We estimate the potential leakage from unmanaged transaction costs is of the order of 0.25% per annum[6].

The government now has an opportunity to address these issues. Focussing on cost minimization misses that opportunity.

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[3] Alpha Forecasts: Liquid Assets, Russell Research, April 2012

[4] Internal Russell research

[5] Journal of Portfolio Management, 14, no. 3 (spring 1988): 4-9.

[6] The managed implementation advantage: Savings realised for investors in multi-asset portfolios , Russell, January 2013

Strong implementation requires strong governance: that means effective delegation

By strong governance we mean not only strong oversight from the governing body, but also effective execution through delegation. This means the selection and empowerment of skilful agents to execute the strategy, extracting value and managing volatility. The Government's current proposals seek to capture efficiencies from economies of scale. For value maximization, however, scale alone is not sufficient.

The value of strong governance

Proper control and realization of the strategy comes from the timely and effective implementation of many subsidiary judgments and decisions in real time. Decisions within and across all parts of the portfolio are applied to enhance returns and to control volatility. These decisions cannot all be controlled directly by a governing body, which is typically non-expert and meets only periodically. Strong governance applies resource and effective delegation to replace the illusion of control with real control. There are few concrete estimates of the value of strong governance, but the most robust study that we have seen puts the difference in active management performance between well governed funds and weakly governed funds at 2.4% per annum.[7]

The traditional model is not working well in today's markets

The traditional model is for pension funds to take advice on strategy and matters of implementation, and to execute these directly or require that all execution decisions be explicitly approved by them.

A recent Russell survey[8] found that despite UK pension funds increasing resources, trustees are delegating very little decision-making, using those resources to advise rather than to execute. For example, 88% of in-house teams have no authority to make any decisions without explicit approval from the trustee body. For investment committees, where they exist (42% of schemes had no investment committee), 45% have no decision-making authority.

There are a number of consequences, all of which serve to widen the gap between strategy and execution:

- cumbersome and long-winded approval processes;
- constraints on the range of investment choices considered to fit the limits of time and expertise at the governing (trustee) level;
- a focus on periodic product selection over other aspects of real-time execution;
- under-utilisation of skilled resources, potentially limiting value for money.

This is like choosing to represent yourself in court. You may well be very well advised, but when the unexpected happens you are unlikely to have the courtroom skill or legal knowledge to deal with it effectively in the moment. By the time you have consulted with your legal advisers, it is likely that the damage to your case has already been done. Barristers really can do a better job when they represent you in court. So it is with investment: advice is no substitute for day-to-day skill in the field.

We understand that the Scheme largely operates under the traditional model. The Government should consider how the Scheme's scale can be used to create a skilled executive to which the local fund authorities can delegate execution.

Structuring for Success

The government should focus on structures with broad remits to maximise value

We support the retention of strategic decision making at the local fund authority level. However the Government should focus on identifying structures that enable effective delegation and implementation of those strategies.

In particular, the government should consider widening the remit of any collective vehicles beyond the implementation of passive mandates. The vehicles should have the flexibility

[7] The Pension Fund Governance Deficit: Still With Us, Keith Ambachsteer, Ronald Capelle, Hubert Lum, Rotman International Journal of Pension Management, Fall 2008.

[8] Survey of 300 UK defined benefit pension funds conducted in September/October 2013, report forthcoming

to include the full range of implementation options, including active and passive – and everything in between, such as 'smart beta'.

Local fund authorities could be required to justify any decision to implement outside the collective vehicle, for example to use passive or to use competing active vehicles. The 'comply or explain' approach should help ensure that the collective vehicles remain competitive.

Addressing the Government's 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.

In principle we agree. The benefits of scale in investment management are clear.

Investment management fee arrangements reward scale. However the data confirms that the Scheme has largely been successful in securing low fees from its providers for listed assets. As such, the fee saving benefits of aggregation are at best marginal for the Scheme. The cost saving identified is principally by adopting a passive rather than an active approach.

However, focusing on cost savings rather than extracting value has resulted in limiting the mandate of the common vehicles for listed assets to wholly passive implementation. This means the real opportunity is lost: the opportunity to upgrade the Scheme's access to greater expertise by increasing purchasing power – not just of investment product but of professional expertise at a range of decision-making levels.

As discussed above, scale alone is not sufficient for success, it needs to come with strong governance and enabled decision-making. Studying large pension funds is therefore not by itself instructive, the analysis must separate the well governed from the weakly governed.

There are also risks associated with scale. Scale can act as a deadweight to effective investment if it comes with increased bureaucracy. It can make it difficult to access more niche opportunities. And it can make it more difficult to act nimbly, as trades are large in size and more visible to other market participants. Managing these challenges will be particularly pertinent for the Scheme's investment in alternative asset classes, where capacity is typically more limited.

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

We agree that strategic decisions should be kept with the local fund authorities. If the need for local accountability disallows a merger, the local fund authorities must be able to set the strategic course and be accountable for it.

However, care must be taken as to what constitutes a strategic decision. Asset allocation is often equated with strategic decision-making. This received wisdom has its origins in a famous study[9] which showed that over 90% of the variation in returns of a portfolio is attributable to asset allocation rather than stock selection. That study has been much debated and challenged in the intervening years, but it is widely agreed that strategic asset allocation is the main driver of risk.

However, studies such as this define asset allocation at only the broadest level. They also explicitly exclude any tactical asset allocation adjustments. Also, '90% of the risk' is very different to '90% of the return'.

The more granular the asset allocation decision, the greater the expertise that is required to make that decision. One way to look at it is to consider the correlation between assets.

- At the highest level, for example listed equities versus investment grade bonds, correlations are relatively low. The historic correlation between global listed equities and global investment grade credit was 0.31.[10] This means that distinguishing between

[9] Determinants of Portfolio Performance, Brinson, Hood & Beebower, Financial Analysts Journal, July/August 1986, Vol 42, No. 4:39-44

[10] Source: Bloomberg: Russell Calculations (Barclays Global Agg Corporate Index vs. Russell Developed Index) Monthly data since 29/09/2000

these types of assets and defining their respective roles in the portfolio is reasonably straightforward.

- As asset allocation decisions become more granular, for example choosing between different regions of equity, correlations rise and it becomes more difficult to distinguish between them.

	Russell 3000 Index	*Russell UK*	*Russell Europe xUK*	*Russell Asia Pacific*
Russell 3000 Index	1			
Russell UK	0.86	1		
Russell Europe xUK	0.87	0.89	1	
Russell Asia Pacific	0.76	0.72	0.77	1

Source: Russell

A range of other inputs and expertise is increasingly required to make these more granular allocations, and choices may become more driven by return considerations.

As such, we believe that care must be taken in defining which asset allocation decisions are truly strategic. More granular decisions (for example, whether to include leveraged loans within a credit portfolio) or tactical decisions (for example, whether to add short-term equity downside protection) should be delegated.

We believe that a strategic intent can be fully expressed through allocations to equity, credit, real assets, skill-based strategies and liability-matching strategies.

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 vehicles?

Common investment vehicles should enable implementation of strategic choices. As such, the choice should align with the definition of what constitutes strategic. From the discussion above we believe that vehicles for equity, credit, real assets and skill-based strategies will suffice. We exclude liability-matching strategies because those are by their nature bespoke to the local funds.

The broader the definition of the common investment vehicles, the greater the scope for skilful management to add value, through either or both enhanced returns or volatility management.

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

It is premature to precisely define governance arrangements, if the Government is to consider the proposals we set out here. There are, however, a number of core principles that we believe should inform any choice of governance arrangements:

Delegation to expertise, not representation

If delegations are made to non-experts to satisfy a preference for stakeholder representation, then little is gained in terms of execution ability. It is sometimes argued that including non-expert representatives in investment committees or similar bodies can ensure that the decisions taken can be more widely understood and communicated to other stakeholders. However we believe this can be achieved through transparency of information, and oversight bodies being effective in challenging their delegates and holding them to account.

Accountability

Clear objectives and metrics for success must be established for delegates, together with discretions and boundaries appropriate to their expertise. It must be clear from the outset that they are accountable for delivering on those objectives.

Transparency with confidentiality

Ensuring transparency and clear lines of communication is an essential tool in holding delegates to account. However, given the Scheme's scale there are limits to transparency, as the Scheme will not want to signal its actions to the markets in advance.

Finding the right balance between these two opposing forces will require careful consideration.

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.

We propose an alternative option – common investment vehicles with professional management empowered to take a broad range of implementation decisions in order to maximize value in implementing the strategic building blocks.

As described above, we believe that four common investment vehicles would enable the local fund authorities to implement their strategic preferences: equity, credit, real assets and skill-based strategies. Broad discretion can be granted within those vehicles to:

- construct portfolios, combining a range of strategies across the range from active to passive.
- dynamically manage the line-up of strategies as opportunities evolve and fade away.
- tactically adjust exposures at different points in the market cycle to manage risks or boost returns.

Fund authorities could be required to implement their strategies through the common vehicles on a 'comply or explain' basis.

Closing comments

Ensuring that the Scheme is getting value for money should and will remain a core objective for the Government. Economies of scale can clearly contribute to that aim.

However, we challenge the inferred conclusion from the analysis conducted to date that active management offers poor value. It is incumbent on the Government to examine ways in which value can be better extracted from active management. Without doing so, the Government removes all opportunity to participate in a source of return that could, with diligent management, provide a meaningful source of funding to the Scheme. That is an opportunity cost that is too large for the Scheme to accept without further examination.

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