Russell Investments

Local Government Pension Schemes: Solving the Governance Challenge

Local Government Pension Schemes have come under intense scrutiny over recent years; an increasing number of opt-outs, decreasing contributions and maturing schemes have resulted in pressure from Whitehall to improve governance, reduce costs and implement ideas and services more efficiently. There has been an increasing sense of urgency, exacerbated by weak domestic growth and a rising public awareness about the resolution of these issues, resulting in collaboration between schemes and greater input from central government. Some commentators have called for a more radical solution; we believe that a fresh approach can be provided by partnering with a specialist.

The Challenges

Rising Costs

In March 2011 Lord Hutton produced a report which identified a number of challenges facing Local Government Pension Schemes. At the centre was how much public sector pensions will cost as a percentage of GDP in the coming year. Hutton identified that public service schemes paid out £32bn in 2008-09, which was about two-thirds of the cost of the basic state pension.[1] The gap between contributions and payments is expected to rise from £4.5 billion in 2010-11 to £9.7 billion in 2014-15.[2] Critically it is the taxpayer who bears this cost.

Stretched Resources

Compounding the issue of cost is the constantly changing financial landscape and the increasing strain on pension executives to move quicker and achieve more with the same stretched resources.

- Increasingly mature Local Government Pension Schemes and decreasing contributions have meant that pension executives have to pay far more attention to their liability profile and degree of risk tolerance, culminating in a unique investment strategy. The manager roster no longer consists of one or two balanced managers tasked with outperforming an industry median benchmark, but rather an increasing number of managers responsible for performance returns relative to liabilities
- Weak domestic growth and a range of austerity measures have increased the pressure on Local Government Pension Schemes to improve returns, often through more complex investments. This includes allocating a greater proportion of their assets to international investments, alternatives and active management strategies.

These changes have dramatically altered the requirements and work load on pension executives; the responsibilities have increased without a commensurate rise in resources.

Inefficient Decision Making

Both of the above factors mean that pension executives have to respond more quickly to market events and conditions in order to be successful, with Local Government Pension Schemes now attempting to react more dynamically to perceived short-term market opportunities.

Efficient decision making has therefore become vital. The dynamic between pension executives and advisors can however result in investment decisions taking up to 6 months to formulate. Once a decision has been reached the majority of Local Government Pension Schemes are at the mercy of the onerous Official Journal European Union (OJEU) procurement rules which can take a further 6-18 months to navigate, significantly reducing the value of the original decision.

---

[1] Hutton Report, March 2011
[2] Michael Johnson, Public Sector Pension: a catastrophe for UK plc

The Current Solutions

Fund Panels

Fund panels have been promoted as one method of giving Local Government Pension Schemes access to a range of services and investment products without having to continuously navigate the OJEU tender process.

A fund panel is created by a single scheme procuring investment services with only one OJEU process to complete. They aim to speed up the decision making process by providing the scheme with a ready-made selection of managers or service providers. The scheme can either subscribe or redeem from one manager as it sees fit, or diversify its investments across a number of managers. For example a scheme may construct a panel of 10 global equity managers and can invest in any number of these managers at any one time. Should they choose to amend their exposure they can change managers without having to re-navigate the OJEU process, freeing up time to focus on strategy and decision-making.

Framework Agreements

Framework agreements offer similar advantages to fund panels, but are tendered by multiple Local Government Pension Schemes. This can leverage economies of scale to procure services from investment managers or service providers, helping drive down costs and also freeing up resources. It can also result in improved governance, effectively learning from each other rather than attempting to become specialists across the entire spectrum of the investment universe.

A Radical Solution

In January 2012 a group of Local Government Pension Schemes and some key industry academics wrote an open letter to the Financial Times highlighting the structural inefficiencies prevalent within Local Government Pension Schemes. They contended that in order to achieve real efficiency and dramatically reduce costs, the 101 public sector funds should be amalgamated into five larger funds each with assets of circa £30BN. It is argued that this would fundamentally change the ability of Local Government Pension Schemes to gain economies of scale, therefore improving efficiency operationally and in the procurement of services.

Partnering with a Specialist

Fund panels and framework agreements can be used to limit the need to continuously re-tender. However, they still require significant resource, time and skill to be employed by pension managers to be truly effective and often suffer from stagnation.

The suggested wholesale restructure of the Local Government Pension Scheme landscape is fraught with difficulties; political allegiances, significant size differences and diverse funding and liability profiles may make it difficult to achieve a universally accepted solution.

To truly improve governance, increase resources and achieve greater efficiency pension executives may wish to consider partnering with a specialist to help achieve these aims.

Fiduciary Management

Fiduciary management is a cost-effective solution which equips pension executives with the ability to gain control over the long-term direction of their scheme. By taking responsibility for the day-to-day management of assets relative to liabilities, a fiduciary manager can allow pension executives to focus on strategic issues which can improve governance and, ultimately, the scheme's funding ratio.

Partnering with a fiduciary manager could enable Local Government Pension Schemes to reduce costs, improve decision making and increase resources.

Reduced Costs

Reducing the gap between payments and contributions is vital to reducing the cost of Local Government Pension Schemes. However, with actuarial reviews only carried out on a triennial basis, and often little information provided during the intervening years, scheme funding ratios are often at the mercy of financial markets.

Pension executives can utilise the expertise of a fiduciary manager to formulate a longer-term strategy where the funding level is managed on a more frequent basis, increasing the focus on the liabilities and managing any deficit. By taking the responsibility for the daily monitoring of assets and liabilities, the fiduciary manager can ensure the portfolio is appropriate for the current funding position, reducing risks and costs when affordable to do so. This risk reduction for Local Government Pension Schemes also means that as the funding level increases, and the deficit reduces, there is less chance of the deficit increasing again in the future.

Efficient Decision Making

Key to achieving a fully funded status is the ability to make decisions about the long-term strategy, and execute them effectively. This also includes how the strategy takes account of changing market environments, and the efficiency with which opportunities can be captured and unnecessary risks avoided. Many Local Government Pension Schemes are, as previously outlined, hindered in their ability to respond effectively to market events.

Pension executives can work with a fiduciary manager to develop a framework around decision-making. The fiduciary manager will work with the pension executives to explore the desired decision-making structure, resulting in a bespoke framework around each decision. This enables the pension executives to gain greater control over decision making, whilst removing some of the time and cost burden. Furthermore, it creates the opportunity for Local Government Pension Schemes to be as proactive to market changes as the pensions executives wish, with the ability to exploit market opportunities and mitigate market risk.

Increased Resources

To maximise the use of investment opportunities and deliver an efficient strategy, many Local Government Pension Schemes have increased the range of asset classes used. This has in turn meant greater numbers of specialist investment managers are employed, resulting in a greater burden on pension executives in monitoring, reviewing and revising the investments and managers.

Employing the expertise of a fiduciary manager gives schemes access to a breadth and depth of resources which can help reduce this burden significantly. Pension executives can focus on their desired portfolio characteristics whilst utilising the fiduciary manager's expertise in implementing the strategy. This includes drawing on the fiduciary manager's experience and resources in capital markets research, manager research and portfolio management and can prove more cost-effective than employing multiple providers.

Multi-Asset Portfolio Management

Many Local Government Pension Scheme executives are focussed on achieving a fully funded status, which is reflected in asset allocations typically weighted towards return seeking investments, such as equities. Recent performance in equity markets has caused many pension executives to consider other return seeking investments, diversifying the sources of return to gain a smoother expected return pattern. However, the ability to diversify effectively, across multiple managers and asset classes is often hindered by the OJEU process.

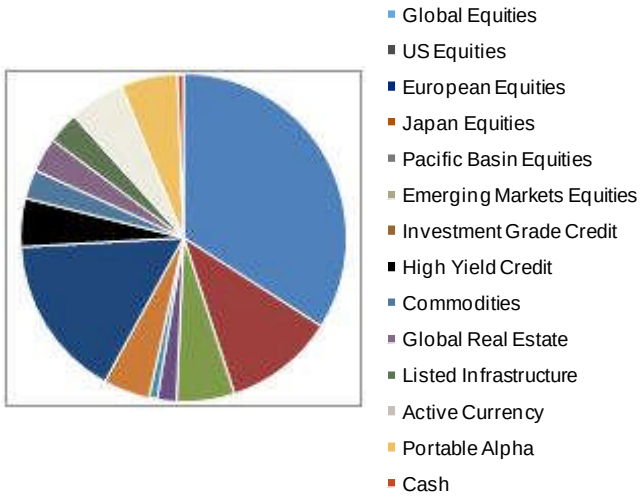
Once the decision to diversify has been made, pension executives are faced with a number of further practical challenges:

Asset Allocation: Which new asset classes and strategies should you include? How much should you allocate to these investments? When should the strategy be reviewed and amended? How do you introduce tactical views into your decision-making structure?

Manager selection: How do you identify superior managers, especially in niche investment areas? How do you gain access to the superior managers cost-effectively, especially if you have small allocations? How do you monitor multiple managers across multiple disciplines on an ongoing basis?

Implementation: With an increased number of managers, strategies and allocations, how do you ensure that you can manage your exposures efficiently? How do you ensure that you remain focused on returns and do not introduce unrewarded risks?

ILLUSTRATIVE MULTI-ASSET ALLOCATION



Framework agreements and fund panels may circumvent the OJEU process and diversify manager risk, but they tend to be specific to a particular asset class.

Delegating responsibility for asset diversification to a skilled multi-asset portfolio management team ensures the scheme can react to market changes and dynamically allocate across different asset classes when necessary. This not only provides scheme executives with the potential to reduce risk and enhance returns but also allows executives to focus on core objectives such as establishing a strategic glide-path to a higher funding ratio.

Manager of Managers

The construction of framework agreements and fund panels are still subject to the OJEU process. These agreements also have a term of up to four years. In order to reap the benefits of an agreement a scheme would usually have a number of managers in place for this period. However, this means that schemes can only select managers from a limited universe of managers on the panel, and crucially they are tied to this universe for up to four years. What may be the best manager in year one may not be the best manager in year four.

To address this issue from an investment manager perspective, a multi-manager structure can be utilised. This involves the Local Government Pension Scheme investing in a portfolio which has an asset class definition, for example global or emerging market equities, but with the underlying managers being selected, monitored, reviewed and sometimes replaced by a multi-manager portfolio provider.

This enables best in breed managers to be continuously selected and monitored from an entire universe of managers, with the multi-manager provider being accountable for the optimal combination of managers in the fund. This specialist input of which managers to combine and in what allocations can not only help produce smoother expected returns, but also removes from pension executives the further burden of allocating between the managers.

The production of positive returns is not just the selection of good managers; rather, it is the continuation of full-time experts combining their specialist skills to ensure the correct portfolio management decisions are made.

Delegating responsibility for manager selection and managing the combinations of managers within an asset class gives the pension executives access to specialist individuals who manage the portfolio and managers on a full-time basis, taking advantage of market changes and responding to manager performance at the appropriate time. This also frees up time, allowing pension executives to pay greater attention to long-term strategy and funding levels.

Local Government Pension Schemes can be very sensitive to fees; a Fiduciary Manager, Multi-Asset or Manager of Manager solution must be able to prove that compared to other governance structures they offer a cost effective solution. Managing costs embedded within these structures is one of the critical elements to success - when selecting a provider it is vital that this is taken into consideration.

Summary

	Framework/Fund Panel	Partnership Approach
Decision making	Complex decision-making process	Dynamic decision-making process able to proactively take account of market changes
Coverage	Restriction of framework agreement/fund panel to single asset class	Ability to employ multi-asset and dynamic allocation across a variety of asset classes and managers
Best Ideas	Static research to appoint the best managers at the point of the framework agreement/fund panel inception	Continuous full-time research to select the best ranked manager combinations for entire duration of portfolio, without the need to revisit the OJEU process
Portfolio Construction	Static manager line-up – relevance and suitability after 1, 2, 3 or 4 years?	Portfolio management to ensure optimal manager combinations are always present in the fund
Resources	Ability of pensions executives to select and de-select managers at the appropriate time, plus manage the mix between various managers	Ability of portfolio managers to select and deselect managers at the appropriate time, and actively manage the mix between managers
Focus	Pension executives distracted from making strategic investment decisions	Pension executives focus on strategic decisions and funding level

Closing Thoughts

The challenges facing Local Government Pension Schemes are complex and varied in their nature. Increasing costs, complex governance structures and inefficient implementation have resulted in an unprecedented degree of pressure from Whitehall.

A number of initiatives have allowed Local Government Pension Schemes to take steps in overcoming these challenges, however to fully meet these challenges necessitates input from dedicated specialist service providers.

By partnering with a specialist, pension executives can achieve greater control over the long-term direction of their scheme whilst significantly improving governance and increasing their potential to meet liabilities.

For more information:

Call Gavin Lewis at Russell Investments on **+44 (0)20 7024 6353**

glewis@russell.com

Important information

This material does not constitute an offer or invitation to anyone in any jurisdiction to invest in any Russell product or use any Russell services where such offer or invitation is not lawful, or in which the person making such offer or invitation is not qualified to do so, nor has it been prepared in connection with any such offer or invitation.

Unless otherwise specified, Russell Investments is the source of all data. All information contained in this material is current at the time of issue and, to the best of our knowledge, accurate. Any opinion expressed is that of Russell Investments, is not a statement of fact, is subject to change and, unless it relates to a specified investment, does not constitute the regulated activity of "advising on investments" for the purposes of the Financial Services and Markets Act 2000.

The value of investments and the income from them can fall as well as rise and is not guaranteed. You may not get back the amount originally invested.

Any forecast, projection or target is indicative only and not guaranteed in any way. Any past performance figures are not necessarily a guide to future performance.

Any reference to returns linked to currencies may increase or decrease as a result of currency fluctuations. Any references to tax treatments depend on the circumstances of the individual client and may be subject to change in the future.

Issued by Russell Implementation Services Limited. Company No. 3049880. Registered in England and Wales with registered office at: Rex House, 10 Regent Street, London SW1Y 4PE. Telephone 020 7024 6000. Authorised and regulated by the Financial Services Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS.