Common Investment Funds (CIF)

Could there be benefits from LGPS Authorities forming Common Investment Vehicles?

Laura Rowley CIPFA Pensions Conference November 2014

Setting the scene – Is there a need for change in the LGPS?

LGPS Funds are each managed separately and invested individually with their own appointed investment managers and custodians.

LGPS Funds benefit from professional management of their assets, independent investment advice and access to a diversified portfolio of assets.

What issues should be considered by LGPS Fund Administrators when considering collaboration?

What are the potential benefits of CIFs for LGPS and are there pitfalls/hurdles to manage?

Is there any evidence that collaboration through a CIF works?

The Characteristics of a CIF

- A pooling arrangement, not a merger of Funds
- Each participant maintains its own Governance arrangements (Pension Committee)
- Each participant has its own Investment Strategy
- There is no loss of autonomy or decision making for participants
- It is a collaboration

The Characteristics of a CIF

- A CIF is an administrative management vehicle, not a separate legal entity or separately constituted fund
- It is simple to operate once set up and reduces annual running costs.
- It provides the foundations for adding new (and removing) investment pools efficiently – one process for appointing a list of investment managers rather than many
- Investment management fees will reduce – all participants will benefit from the lowest negotiated fees
- It will provide the opportunity for smaller funds to have broader opportunities for diversification of investments in a cost effective way
- It provides opportunities for savings from cross trades during transition between managers and asset classes

Issues to consider

Criteria	Options	
	Continue with Segregated Portfolios	Common Investment Fund
Meeting the objectives of the individual funds	No change, individual funds objectives as set out in their investment strategies will be met.	No change, individual funds objectives as set out in their investment strategies will be met. However, there will be the opportunity for smaller funds to invest in asset classes they previously would not have had the opportunity to invest in.
Costs / Cost Savings	No change.	Significant cost savings achievable due to economies of scale and one larger, more diverse set of Investment Managers and Custodian.
Risk management	Larger funds have adequate control over diversification, smaller funds do not have the same opportunities under this option.	Potential to improve risk management, with greater diversification of investment portfolios aligned with investment strategies.

Issues to consider

Criteria	Options	
	Continue with Segregated Portfolios	Common Investment Fund
Ease of administration	Already in place therefore continue with current practices.	Initially some change in current practices. However, a unitised model for accounting should simplify the process, making administration more manageable.
Management of portfolios, custodians and investment managers	More difficult to manage as each Fund will have its own investment managers, custodians and underlying assets. Therefore more performance management and monitoring is required. Fees overall will be higher.	This will simplify the management as there will be one larger, more diverse, common group of investment managers and custodianship of underlying assets across all funds investing in the CIF.

The hurdles at the start

During the initial construction of the CIF, there is considerable investigation required between the proposed participants, advisors and lawyers to establish the best route to pooling Investments.

Here are the key considerations when designing the CIF for a cluster of authorities ……….

Considerations when designing the CIF

- Legal structure: a pooling arrangement vs a Regulated Unit trust?
- Tax Structure: get early advice on the most efficient Tax Structure
- Operational structure:
  - Flexibility and scope needed by the CIF to build on the existing Investment asset classes and introduce new asset classes once established
  - Early action can be taken to aggregate existing common mandates and reduce fees
  - Maximum limits can be introduced for Investment Managers – reducing exposure to Manager Risk for the LGPS as a whole
  - Dealing Frequencies for units can be determined to give easier, faster and cheaper access and exit from individual managers and asset classes

Considerations when designing the CIF

- How to account for the CIF (Fund accounting, performance measurement, Unit Pricing)
- Defining the role of the Custodian and the accounting service they can provide.
- Deciding on the security of assets and where they should be held.
- Establishing effective methods for the transfer of assets into the CIF – passive funds first and actives later? By asset class?
- Establishing effective methods for introducing new participants and when they are able to join
- Transition of assets outside of the CIF into the CIF – using Bid offer Spreads after inception.
- Governance Structure for the CIF- establishing a representative Board of a manageable size for decision

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Under starter's orders:

Before the formal declaration of intent by an Authority, a significant amount of work needs to be completed to assess and shape a Common Investment Fund for a cluster of participating authorities.

Here are the key stages in the development of a CIF …….

Key stages in the Development of a CIF

Stage	Details	
Planning / Design	Seek independent investment advice about setting up a CIF	
Planning / Design	Seek independent legal advice – to check powers to create the CIF and clarify which funds could enter the pooling arrangement	
Planning / Design	Research with existing Advisor(s) and custodian(s) and make "field trips" to learn from existing best practice	
Planning / Design	Carry out a cost / benefit analysis and risk assessment for the pooling of Investments	
Planning / Design	Define Governance Structure and roles and responsibilities of the Pension Committee Members, Treasurers, Officers, Advisors, Investment Managers, Custodian, participating Authorities	

Key stages in the Development of a CIF

Stage	Details
Approval	Each Pension Committee and Council decides upon its participation
Implementation	Review/ Negotiation and Drafting of contracts with Custodian and IMAs. Signing before go live.
Implementation	Design of CIF rules (governing document for the operations of the CIF) and documentation of processes – with extensive consultation and participation of Authorities
Implementation	Arrange the transfer of any physical share certificates held to custodian in advance of go live
Implementation	Carry out an independent audit of CIF rules and implementation plans
Implementation	Individual Authorities may take the opportunity to review and update their Investment Strategies

Key stages of Developing the CIF

Stage	Details
Implementation	Plan and draft transition arrangements and future shape of the CIF post - transition before going live (consideration of values, close off trade period before switch)
Implementation	Design of CIF accounting and performance reports (includes workshops with key staff and Advisors and Custodian)
Implementation	Further discussions with independent Auditors to consider any implications from a risk perspective.
Implementation	Ensure assets are frozen a few days before go live, asset reconciliations carried out.

Key stages of Developing the CIF

Stage	Details
Go live	Phase 1 all assets transferred in according to the plan agreed with Authorities –
Go live	Pay great attention to the detail at transition ....Ensure accounting aspect works correctly, verify all movements to Custodians source documents carefully
Go live	Carry out an independent audit of transition of assets – phase 1 and Report to participants Open and regular communication with participating authorities throughout
Go live	Phase 2 – Consolidation of common mandates and renegotiation of fees to make savings. Removal/ recruitment of investment managers. Implementation of changes to investment strategies approved by participating Pension Committees to take advantage of opportunities for diversification and access to high performing managers

Evidence that a CIF can work in practice ……

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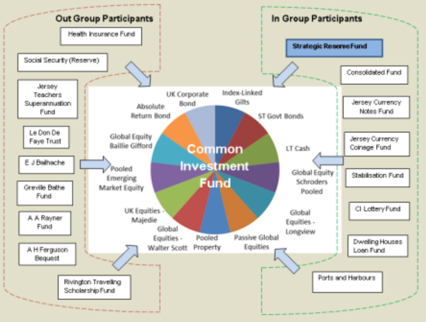
A Practical Example: the Common Investment Fund in the States of Jersey



The attached structure diagram gives a high level summary of the CIF.

Currently the CIF consists of 13 'Pools' each managed by a different manager or combination of managers following a set mandate.

Funds, Trusts, Schemes or States departments investing in the Common Investment Fund are referred to as 'Participants'.

'In Group' Participants are consolidated in the States of Jersey Accounts, 'Out Group' Participants are not consolidated and prepare their own accounts.

Each Participant may invest via their investment strategy as detailed on the following page.
This example will follow the Strategic Reserve as a Participant in the CIF.

Strategy

Each Participant has an 'Investment Strategy' which is presented to the States annually. The strategy gives an asset allocation and sets strategic ranges.

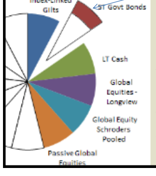
Extract from **Investment Strategy:**
Strategic Reserve Fund:

	Aim	Range
Equities	50%	45-55%
Bonds	40%	36-44%
Alternative	10%	N/a
Cash	0%	0-3%

Asset Allocation Document
Example of ***Strategic Reserve*** *Positioning*

	Strategic Reserve		
	Strategy	Actual	Difference
UK Equities -Majedie	10.0%	10.7%	0.7%
Global Equity - Long view	17.5%	18.0%	0.5%
Global Equity - Walter Scott	17.5%	16.8%	-0.7%
Passive Equity - L&G	5.0%	6.0%	1.0%
Equity	**50.0%**	**51.5%**	**1.5%**
Equity Range	**45-55%**	**51.5%**	
UK Gilts - ST	20.0%	19.2%	-0.8%
UK Index Linked Gilts	0.0%	0.0%	0.0%
Govt Bonds	**20.0%**	**19.2%**	**-0.8%**
ARB	10.0%	9.5%	-0.5%
Combined UK Corp Bond	10.0%	9.7%	-0.3%
Corp Bonds	**20.0%**	**19.3%**	**-0.7%**
BONDS RANGE	**36-44%**	**38.5%**	
LT Cash	0.0%	0.0%	0.0%
Cash	**0.0%**	**0.0%**	**0.0%**
Cash Range	**0-3%**	**0.0%**	
Alternative - Held in govt bonds	10.0%	10.0%	0.0%
Alternatives	**10.0%**	**10.0%**	**0.0%**
Range	**n/a**		
Total	100%	100.0%	0.0%

The '**investment strategy**' dictates the allocation to asset classes. Some asset classes are represented by multiple Pools. The investment advisor recommends allocation between Pools within the strategic range which is summarised in the **Asset Allocation**.



The asset allocation is translated into the Participants actual holdings in the CIF.

These allocations are rebalanced quarterly, or if the strategic range is breached.

Control over Strategy and the operational asset allocation.

Strategic Level

Investment Strategy

Asset Class	Strategic Aim %	Range %
Equities	40	37 – 43
Bonds	45	40 – 50
Cash	15	13 – 17

Controlled by Ministerial Decision

The asset allocation of the CIF is defined at the Participant level. Each Participant has an investment strategy written in consultation with Aon Hewitt, the Investment Advisor ('IA'), this strategy is published in the States of Jersey Investment Strategy doc approved by **Ministerial Decision** and presented to the States by the Minister for Treasury and Resources.

Asset allocation

	HIF Strategic Allocation	HIF Operational Allocation
UK Equities - Majedie		13.0%
Global Equity - Long view		13.0%
Global Equity - Walter Scott		13.0%
Passive Equity - L&G		2.0%
Equity	40.0%	40.0%
UK Gilts - ST		0.0%
UK Index Linked Gilts		0.0%
Govt Bonds		0.0%
ARB		15.0%
Combined UK Corp Bond		30.0%
Corporate Bonds		45.0%
Bonds (Corp/Gilt)	45.0%	45.0%
LT Cash		15%
Cash	15.0%	15.0%
Total	100%	100%

Controlled by Treasurers Decision

The operational allocation complies with the strategic aim.
The allocation between Pools is recommended by the IA and is authorised via a **Treasurers Decision**.
Allocation between Pools will be decided when a Participant enters the CIF.
The operational allocation may not violate the strategic allocation although the Pools may grow or shrink within the strategic range.

Operational level

REBALANCING:	Strategy	Actual	Difference
UK Equities -Majedie	27.5%	27.5%	0.0%
Global Equity - Long view	27.5%	21.5%	-6.0%
Equity Range	**50-60%**	**49.0%**	**-6.0%**
LT Cash	45.0%	51.0%	6.0%
Cash Range	**40-50%**	**51.0%**	**6.0%**
Total	100%	100.0%	0.0%

Controlled by Treasurers Decision

Participants are reviewed on a line by line basis to assess whether rebalancing is required.
Holdings are compared to strategic ranges but the split between managers is also assessed.
Advice will be sought from the IA before a rebalancing takes place.
Rebalancing (or the decision not to rebalance) is subject to a **Treasurers Decision** and performed at least quarterly.

Minister of Treasury and Resources

The Minister is responsible for the presentation to the States of Investment Strategies and delegates authority to the Treasurer to enact them.

Treasurer of the States

The Treasurer is responsible for carrying out the investment of States assets in line with published Strategy.

Treasury Advisory Panel

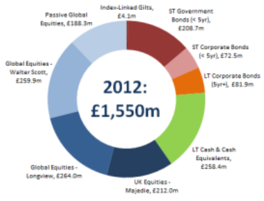
The TAP meet at least quarterly and serves, in the States' governance arrangements, to advise on all strategic matters such as investment strategy. In the States' governance arrangements decisions are made by the Treasury Minister (for the LGPS the equivalent decision making body is the "Pensions Committee') upon advice from the Treasurer who takes into account the views of the TAP.

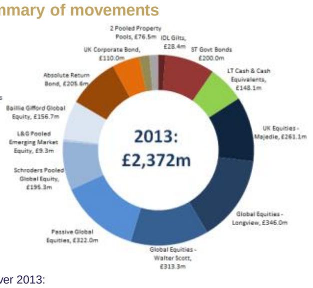
Performance of the Jersey CIF

States of Jersey

States of Jersey – Common Investment Fund

Total CIF: Summary of movements





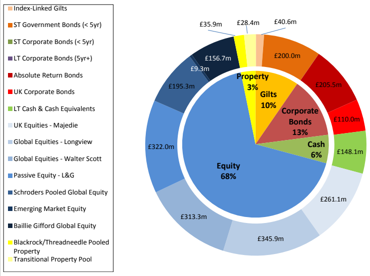
Source of movement:

Of the £822m increase in the value of the CIF over 2013:
•£384m related to the entrance of the 'JTSF' participant;
•£177m related to additional investment by existing participants; and
•£261m related to investment gains generated by the total portfolio.

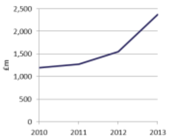
States of Jersey

States of Jersey – Common Investment Fund

High Level Summary – Investment Holdings



Net Asset Value since 2010



A return on investments of 16.4% in 2013

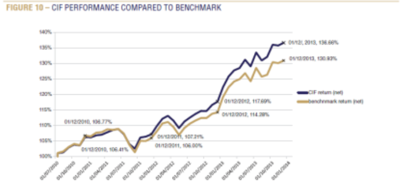
Please note this split does not match the split on page 198 of the accounts as this graph details the net asset value of each pool whereas the split of page 198 just includes the investments

States of Jersey

States of Jersey Accounts Briefing

High Level Summary – Investment Holdings

FIGURE 10 – CIF PERFORMANCE COMPARED TO BENCHMARK

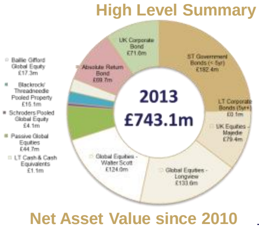


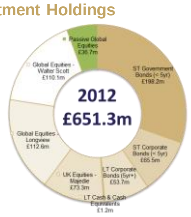
- The CIF allows Special Funds maximise returns, but also provides the opportunity for Trust and Bequest funds under the administration of the Treasury to benefit as well, giving them more money to spend on their charitable causes.

States of Jersey

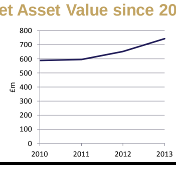
Strategic Reserve Fund

High Level Summary – Investment Holdings





Net Asset Value since 2010



The Fund grew by £91.9 million in 2013.
This is a return on investments of 14.1%

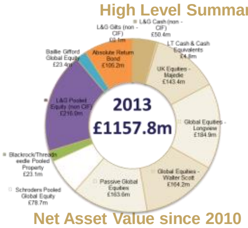
Historic Returns

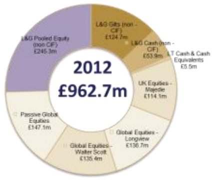
2011 – 1.27%
2012 – 9.61%
2013 – 14.10%

States of Jersey

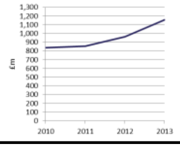
Social Security (Reserve) Fund

High Level Summary – Investment Holdings





Net Asset Value since 2010



Net Revenue of £195.3m

A return on investments of 20.3%

Supporting Detail on Technical Issues

Unitisation

Unitisation is the process by which the activity within a CIF pool is translated into the value of a pools ‘units’.
A worked example is included on the following page.

Income and expense is recorded and controlled at the pool level.

Costs allocated to a pool will include directly incurred fees such as the custodian fees, manager fees and transaction costs.

The pool also pays allocated fees such as investment advisor fees. Investment Advisor fees are apportioned according to any work done directly for the pool (for example work done to amendments of terms of the pools investment manager) as well as the apportioned cost of the investment advisor attending the quarterly Treasury Advisory Panel Meeting.

Any costs attributable directly to a participant would be paid outside the CIF so not to disadvantage other participants.

Treating all participants fairly in the allocation of cost is of paramount importance and arrangements are laid out clearly in the scheme rules to ensure total transparency in the administration of the scheme.

Units can be purchased or sold only on the first day of the month, using the strike price at the end of the month.
Movements in the value of the pool over that month are apportioned to participants in proportion to their unitholdings.

Unitisation: a month from a Participants perspective

Pool

31.12.13 — 1.1.13* — 31.1.13

Closing Balance Sheet 31.12.12

Investments	£99,000,000
Broker Cash	£1,200,000
Debtors	£200,000
creditors	-£400,000
Opening NAV	**£100,000,000**

Unit Register

Strategic Reserve	**5,000,000**
Consolidated Fund	2,500,000
Social Security Reserve	2,500,000
Total	**10,000,000**

Unit strike price:
£100m / 10m units = £10.0 per unit

Any unit trades take place on the first day of the month. In this example we have assumed no change in unit holdings this month.

* Holdings in a Pool are recorded in CIF 'units' and may only be traded monthly on the first day of the month.

This Months Profit & Loss

Investment Income	£500,000
Unrealised gains on investment	£500,000
Bank Interest	£50,000
Income	£1,050,000
Custodian Fee	-£5,000
Invest. Man Fee	-£5,000
Invest. Advisor Fee	-£40,000
Expense	-£50,000
Total Gain	£1,000,000

Closing balance sheet 31.1.13

Investments	£99,500,000
Broker Cash	£1,700,000
Debtors	£200,000
creditors	-£400,000
Opening NAV	**£101,000,000**

Unit Register

Strategic Reserve	**5,000,000**
Consolidated Fund	2,500,000
Social Security Reserve	2,500,000
Total	**10,000,000**

Unit strike price:
£101m / 10m units = £10.1 per unit

In the Pool

Participant: Strategic Reserve

Strategic reserve holds 5m units.
5,000,000 x £10 = £50,000,000

The balance sheet of the strategic reserve will show units in the CIF with a book cost and market value of £50,000,000 as no profit has made been yet.

Assume no unit transactions on the 1.1.13

The profit made by the Pool will be recorded as movement in unrealised value of the CIF units held in the Participant.

Strategic reserve holds 5m units.
5,000,000 x £10.1 = £50,500,000

The balance sheet of the Strategic Reserve will show units in the CIF with a book cost of £50m and market value of £50.5m. The Pool will record £0.5m of unrealised gain on the units.

In the Participant

Bid-Offer Spread: Protecting Participants

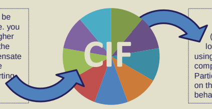
The range of Participants within the CIF have significantly different requirements which is often reflected in their respective cash flows. These differing cash flows often generate opportunities for cross trading of units in cases where a Participant is seeking to invest in a Pool can be matched with a Participant seeking to withdraw.

Cross trading however is not always possible and consequently large inflows of cash into a Pool are likely to generate costs for that Pool as that cash is converted into investments. Inversely large withdrawals are likely to generate costs for the Pool as underlying investments are converted to cash. Because of the Pooled nature of the CIF a mechanism is necessary to protect invested Participants in the case of large unit movements.

Managers in the CIF are required to periodically submit the estimated cost of investing or withdrawing cash, this information is retained as a bid/offer spread. The spread depends on the liquidity of the underlying Pool assets. the cost of buying selling assets with the LT Cash Pool is negligible while within the property Pool this may be considerable.

The Bid price of a unit is a fixed % lower than the calculated unit price (reflecting the managers spread) an offer inversely is a fixed % above normal unit price.

Significant contributions will be made at the '**offer price**' (i.e. you will buy units at a slightly higher price than calculated using the NAV). This serves to compensate the other Participants for the costs incurred on the converting your cash to 'investments'.



Significant withdrawals will be made at the '**bid price**' (i.e. you will receive a slightly lower price than calculated using the NAV). This serves to compensate the other Participants for the costs incurred on the withdrawing Participants behalf.

To consolidate or not to consolidate?

One of the key issues experienced by the CIF was the accounting treatment for the underlying units held by participants.

The CIF is a pooling arrangement with no legal form, assets held by the CIF are held by the Treasurer on behalf of the States of Jersey – Common Investment Fund. This raised questions to whether each underlying participant should consolidate on a line by line basis their 'share' of the underlying assets or simply recognise the value of CIF 'units'.

The States of Jerseys approach was to prepare a technical paper on the issue, agreed a approach the States of Jersey auditors and apply that approach consistently.

Participants:
In the accounts of participants it was agreed that as individual funds could not claim back underlying assets the unit would be recognised as the investment vehicle in substance and therefore recognised on their balance sheet.

The movement of the value of units would be recognised as an unrealised gain/loss until the unit was sold and the gain/loss realised.

The notes to the accounts however would 'look through' the units to disclose the 'apportioned' results from within the pool and the assets within the underlying pool.

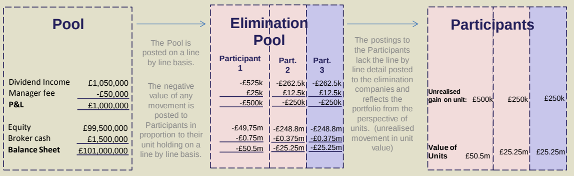
In the State of Jersey Accounts
The accounts of the States of Jersey discloses the full results of the combined CIF and then consolidates the results of all 'in group' participants, which are specially defined in the States 'FReM', on a line by line basis.

The Pool and the Participant and the 'Elimination' process

SOJ account for transactions within CIF Pools but also the 'units' held by Participants.
This is necessary because SOJ needs to effectively monitor the activities of Managers within Pools (on a line by line basis) but also the performance of individual Participant portfolios (as gains on units). Furthermore SOJ needs the ability see the apportioned results on a line by line basis as seen by each individual participants.

The Elimination Pool serves to facilitate consolidation by reflecting results of a pool apportioned to individual participants.
In our simplified example, we show how this operates over a single Pool. In our example **2 participants (pink) are 'in group'** and **1 participant (blue) is 'out group'** with units split 5m, 2.5m, 2.5m respectively.

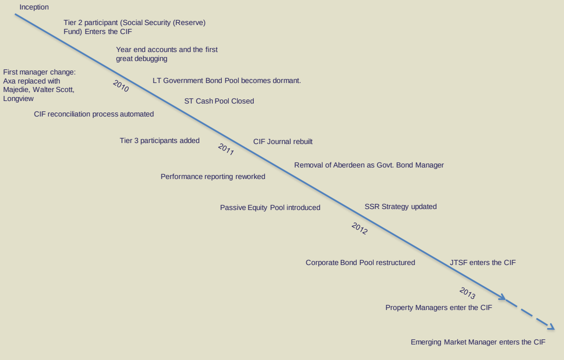
To see the pool from the 'in group' perspective, the 'out group' elimination pool can simply be run at the same time as the pool.



The results above are posted monthly, the allocations are made based on the unit allocation as at the first day of the month. These allocations change monthly as Participants invest, withdraw or rebalance in accordance with their requirements and strategy.

States of Jersey

Key dates from the CIF: On-going Progress



A constant Evolution

As you can see from the prior slide, the CIF has seen constant evolution since its inception, this is better illustrated from the changes seen to the CIF pools and the number of Participants seen on the following 2 pages.

The CIF began as building blocks for different portfolios, but the demands the participants and options it has afforded have allowed it to be grow more precisely meet to the needs of the overall group.

By facilitating the review of the overall position it has enabled the States to better identify both exposure and potential in order to…

Long – Short Pool Structure

Originally the pools of the CIF were designed as building blocks with which a portfolio could be built. As a consequence pools were often split between long and short term pools. The idea was that participants with a longer investment horizon would be able to extract a greater liquidity premium from the long term pools, while investors with shorter term horizons could invest accordingly.

The pool mandates were then built around these ideas with investment limits restricting a managers ability to significantly modify the duration of their underlying assets (so they remained long and short pools).

As the 'risk reducing' portfolios were forced to hold 'safer' asset classes of gilts and cash the managers ability to outperform the benchmark was effectively hobbled from the outset.

Information requirement

The pool/elimination/participant structure of the CIF necessitates a considerable amount of administration and reconciliation.

In a pool with ten participants, a single line of bank interest received as cash requires posting in the pool then apportionment across the ten participants eliminations, and then reposting to the unrealised gain of the pool unit. (44 lines of journal)

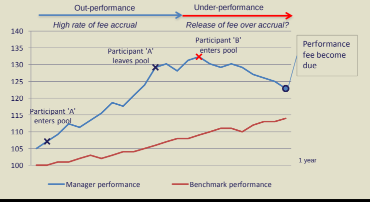
In a complex segregated pool the number of posting requried are considerable, in the average month of the CIF over 6 thousand lines of journal are posted.

Tweaking accruals – the performance issue.

One element which evolved as the CIF progressed was our approach to accruals.

Accurate monthly become more important within a pooled vehicle because of the need to accurately apply costs to a participant during the time they are invested.

One particularly element which remains difficult is performance fees as demonstrated by our simple diagram below. Manager outperformance, in our example, was experienced by 'Participant A' and performance fee would be steadily accrued. Ideally the accrual will cover the total fee paid the second half of the year as Participant B experienced none of the outperformance. However this can be difficult to achieve with the structure of some performance fee arrangements and should be carefully managed and the approach clearly defined on outset.



Lessons Leaned from Core Events

Originally the pools of the CIF were designed as building blocks with which a portfolio could be built. As a consequence pools were often split between long and short term pools. The idea was that participants with a longer investment horizon would be able to extract a greater liquidity premium from the long term pools, while investors with shorter term horizons could invest accordingly.

The pool mandates were then built around these ideas with investment limits restricting a managers ability to significantly modify the duration of their underlying assets (so they remained long and short pools).

As the ‘risk reducing’ portfolios were forced to hold ‘safer’ asset classes of gilts and cash the managers ability to outperform the benchmark was effectively hobbled from the outset.

Inflexibility of bid/offer spreads

The bid/offer spread is applied to internalise the cost of buying/selling units within the participant making the transaction. An example such costs would be a cash purchase of units where the pool would need to convert the cash to, for example, equity, this would incur transaction costs which would be spread amongst the participants already in the pool.

In such a scenario, a participant would be required buy units in the CIF at the ‘offer’ price, a slightly higher price than the NAV value would dictate. The Participant would receive slightly fewer units for their investment effectively compensating the other participants for the additional cost incurred.

However, participants will often purchase units in a CIF pool with a combination of in specie transfers and cash. Due to a limitation to the unitisation process run by our custodian only a single price can be applied to a unit trade in a single month. A single participant cannot but some units at the NAV price and some at the slightly higher ‘offer’ price.

Consequently in such cases a judgement must be made to whether to apply the bid /offer spread.

Income / capital split

Some of the ‘special funds’ investing in the Common Investment Fund are trusts/charities and have underlying terms and conditions which mean they are permitted to spend only income rather than capital gains.

This has caused difficulties as income is effectively ‘internalised’ in the unit price. Any income earned by the underlying pool, whether an appreciation of equity values or bank interest is recognised in the participant only as an unrealised gain on the units they hold.

The solution the CIF applies is to ‘look through’ the units using the ‘elimination’ to recognised the ‘apportioned’ income represented within the units.

This is deemed to comply with the spirit of the wishes of the Donor/Settlers of applicable special funds. The ‘Investment income’ earned by the underlying investments within the CIF Pool can then be distributable by the Trustees, as would have been the case if the investments had been directly owned by the Special Funds.