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Achieving Investment Efficiency

Winter is coming….

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PUBLIC SECTOR

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DCLG Call for Evidence

DCLG / Hymans Research

DCLG “Opportunities” Consultation

Managing Deficits

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DCLG / Hymans Research

ANSWER ME!!!

- Consider 3 Options
  - 1 CIV
  - 5-10 CIVs
  - 5-10 Merged Funds
- Analysis
  - Costs
  - Aggregate performance
  - Benefits and challenges

Outcomes

- LGPS in aggregate (over 10 years)
  - No significant benefit from active management
  - Alternative fees comparatively high
  - Funds negotiate competitive fees

- Costs
  - Passive is cheaper than active (surprise-surprise)
  - Fund merger very expensive

Fund mergers put on ice

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Ploughing ahead…

- DCLG Consultation II
  - Do CIV's save money?
  - Local decision making?
  - How many and what CIVs?
  - Type of CIV / governance?
  - More passive management

Do CIV's save money (does size matter)?

Fee impact diminishes with size

Asset Value	Effective fee
£50m	0.600%
£100m	0.525%
£200m	0.462%
£400m	0.406%
£1bn	0.372%

Scale can drive down fees

Do CIV's save money (alternatives)?

- Existing approach largely uses fund of funds for diversification

	Potential cost saving* (per annum)
Stop using FoFs	c200bps
Direct management**	c300-400bps

* Source: CEM research paper
** Very large funds only – larger than combined LGPS

- Collectivising alternatives could remove layer of fees, but
  - needs scale in order to build dedicated management resource
  - cost savings may accrue slowly

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Can CIV's save money?

- Yes, but
  - Other options could offer similar benefits
  - Savings may take time to be achieve
  - Implementation needs careful planning
  - Governance will be key

Local decision making?

- Objectives
- Attitudes to risk
- Profile of liabilities
  - Maturity
  - Cashflow
  - Range of employers
- Current funding position

How many and what CIV?

Structure of an umbrella CIV

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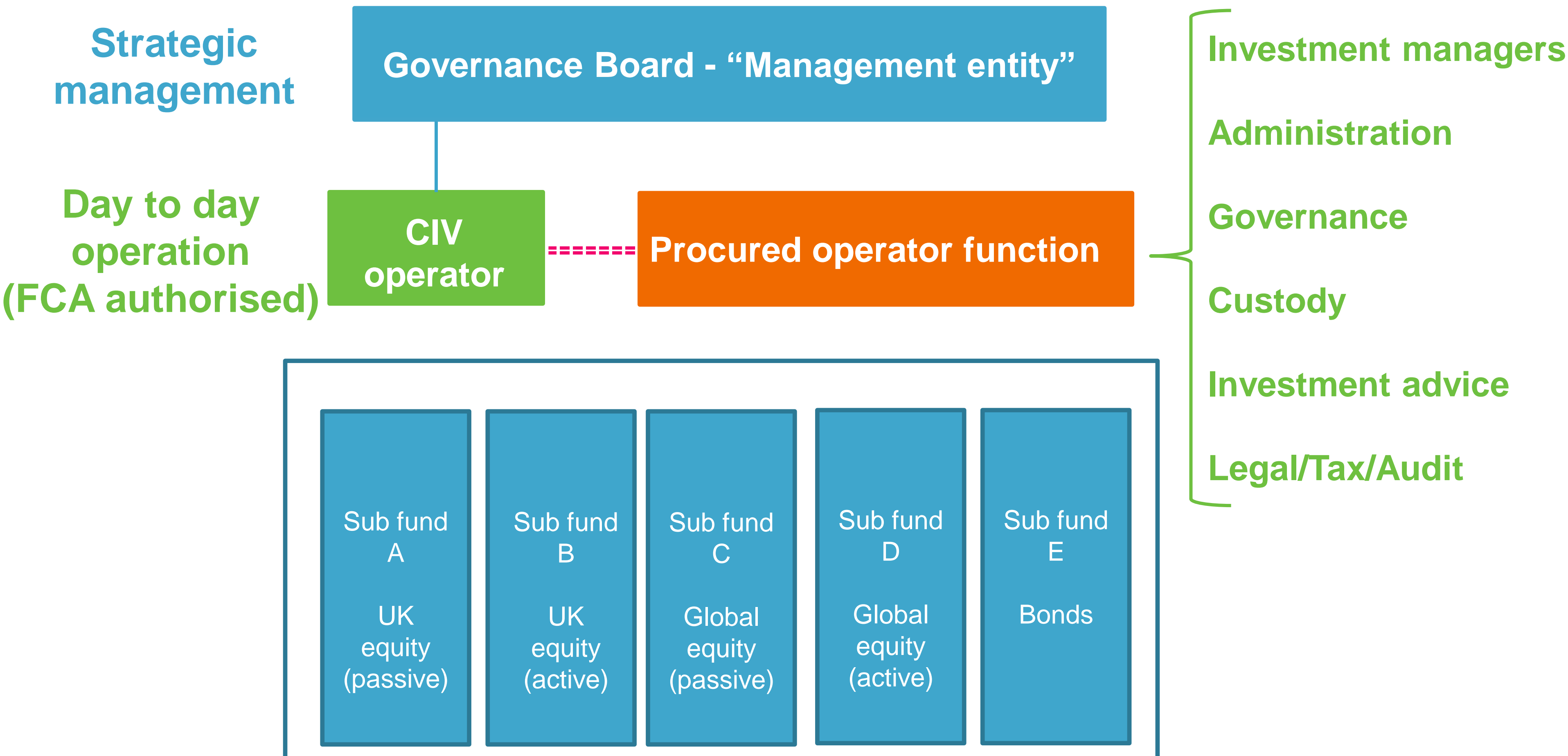

Could operate multi-manager approach within sub-funds

Why would you have more than one CIV?

- Allow participation in governance
- Avoid diseconomies of scale
- Allow for choice
- Type of CIV ‘host’
  - LGPS – interests aligned
  - Corporates – with profit motive

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How many and what CIV?

Focus on core assets

Passive 0-1 CIV

Active 1-10 CIVs

Alternatives 1 CIV

No two snowflakes are the same…

Type of CIV and Governance?

Getting the right tools for the job

Governance – any lessons from the past?

Returns sourced from The WM Company

	2005-2006	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	Annualised
Median return	25.0	7.0	-3.1	-20.3	35.6	8.1	3.0	14.0	**7.5**
Weighted ave.	24.9	7.0	-2.8	-19.9	35.2	8.2	2.6	13.8	**7.5**
Index return	24.1	7.4	-0.7	-16.1	35.9	7.9	1.8	13.0	**8.2**
Ave. - index	+0.8	-0.4	-2.1	-3.8	-0.3	+0.2	+1.2	+0.8	**-0.7**

- Both median and weighted average returns behind fund index return by 0.7% p.a.
- Results in 2007-08 and 2008-09 very influential

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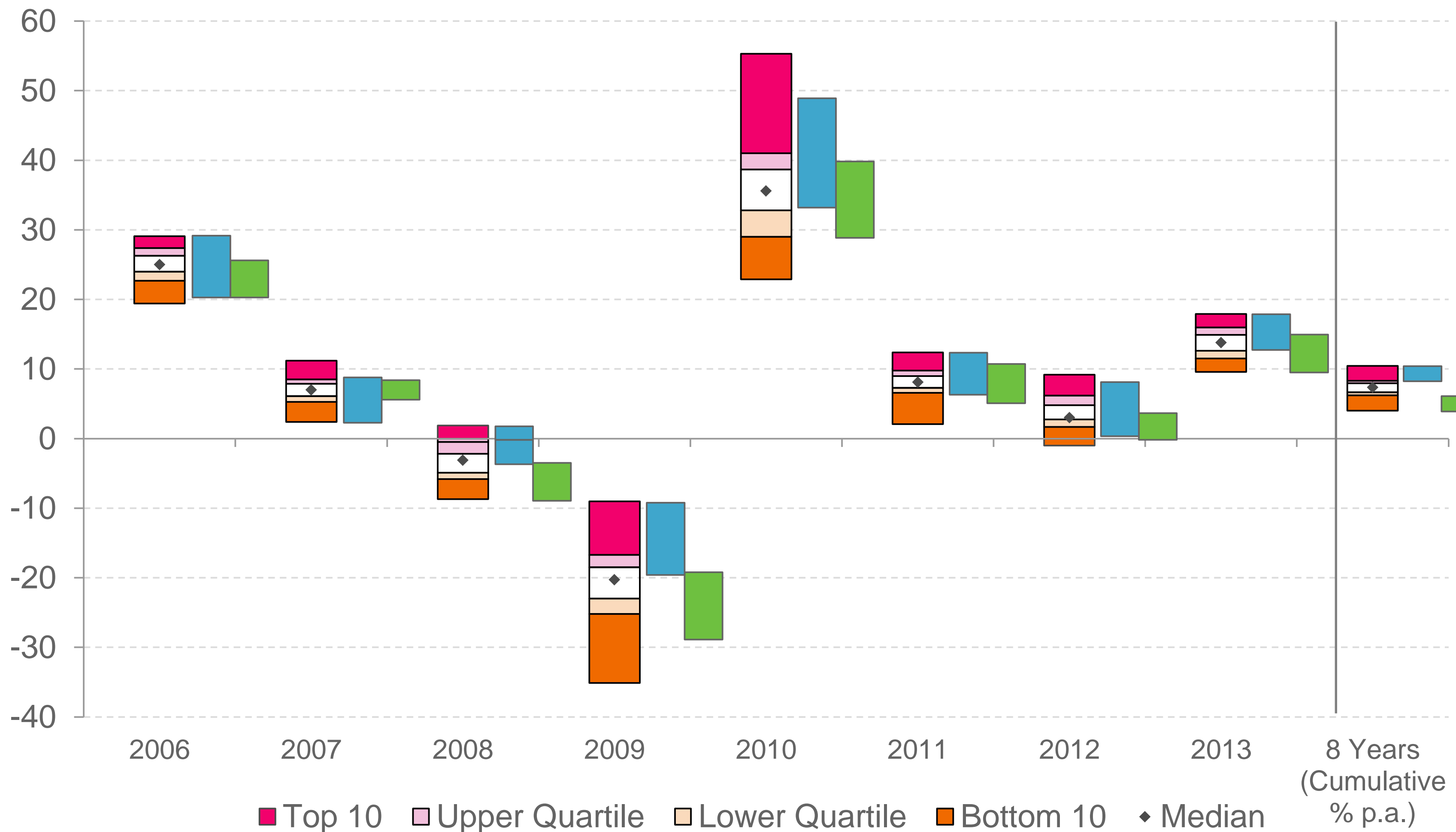
Range of LGPS Returns by Year

For the Top 10 (Bottom 10) performers over the 8 year period, the range of their individual performances in each individual year are shown as the blue (green) bars



Investment structure of top 10 funds

Characteristic	Implication	Caveat
Short manager roster	Reduced governance demands – time to focus on strategy	You need the right managers
Low manager turnover	Reduced costs (transitions)	You need the right managers and patience
Simple structure – equities, bonds and property	Reduced governance demands	Rebalancing discipline required
Evidence of rebalancing to benchmark weights	Avoid strategy becoming either too aggressive or too conservative	Frequency and timing matters

Will these be the same in the future?

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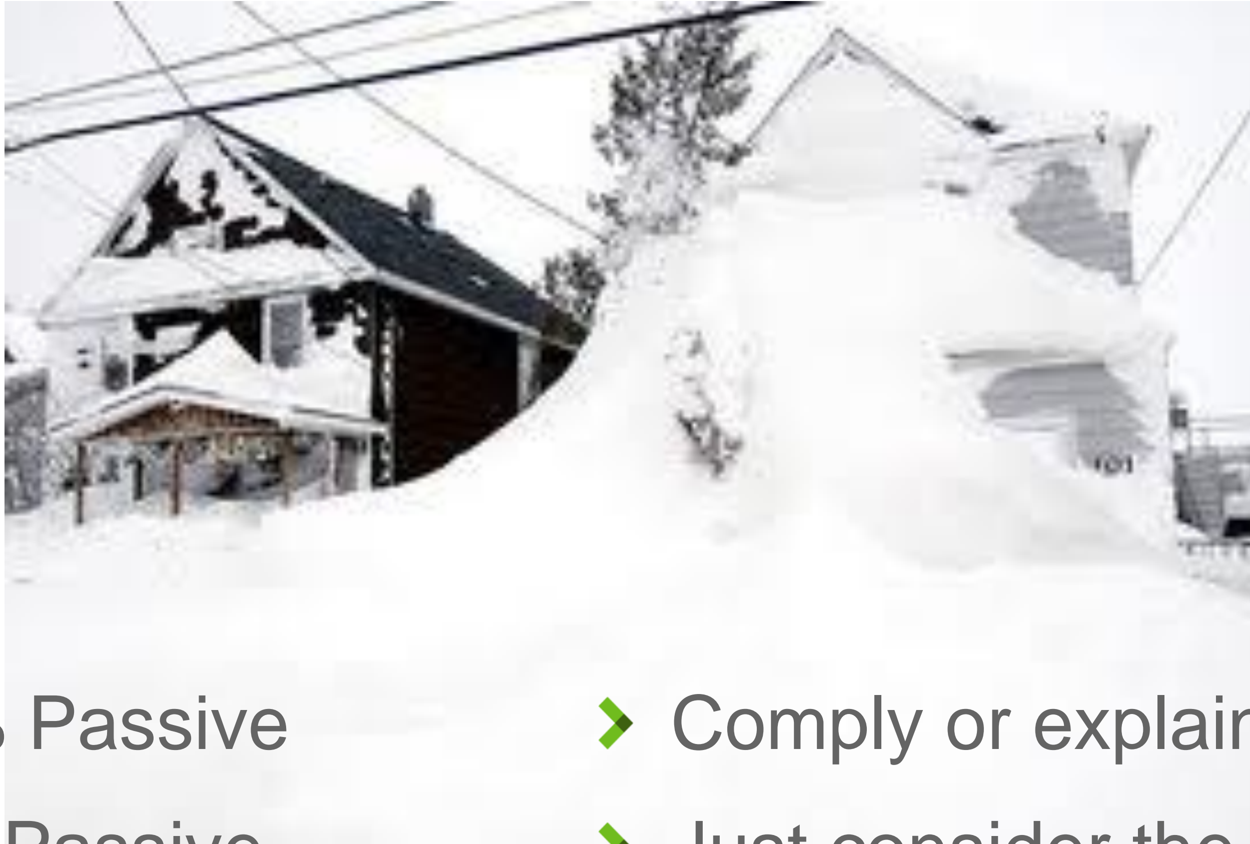
More passive management?



- 100% Passive
- XX% Passive
- Comply or explain
- Just consider the benefits

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BUILDING A PROTOTYPE FOR LISTED EQUITIES

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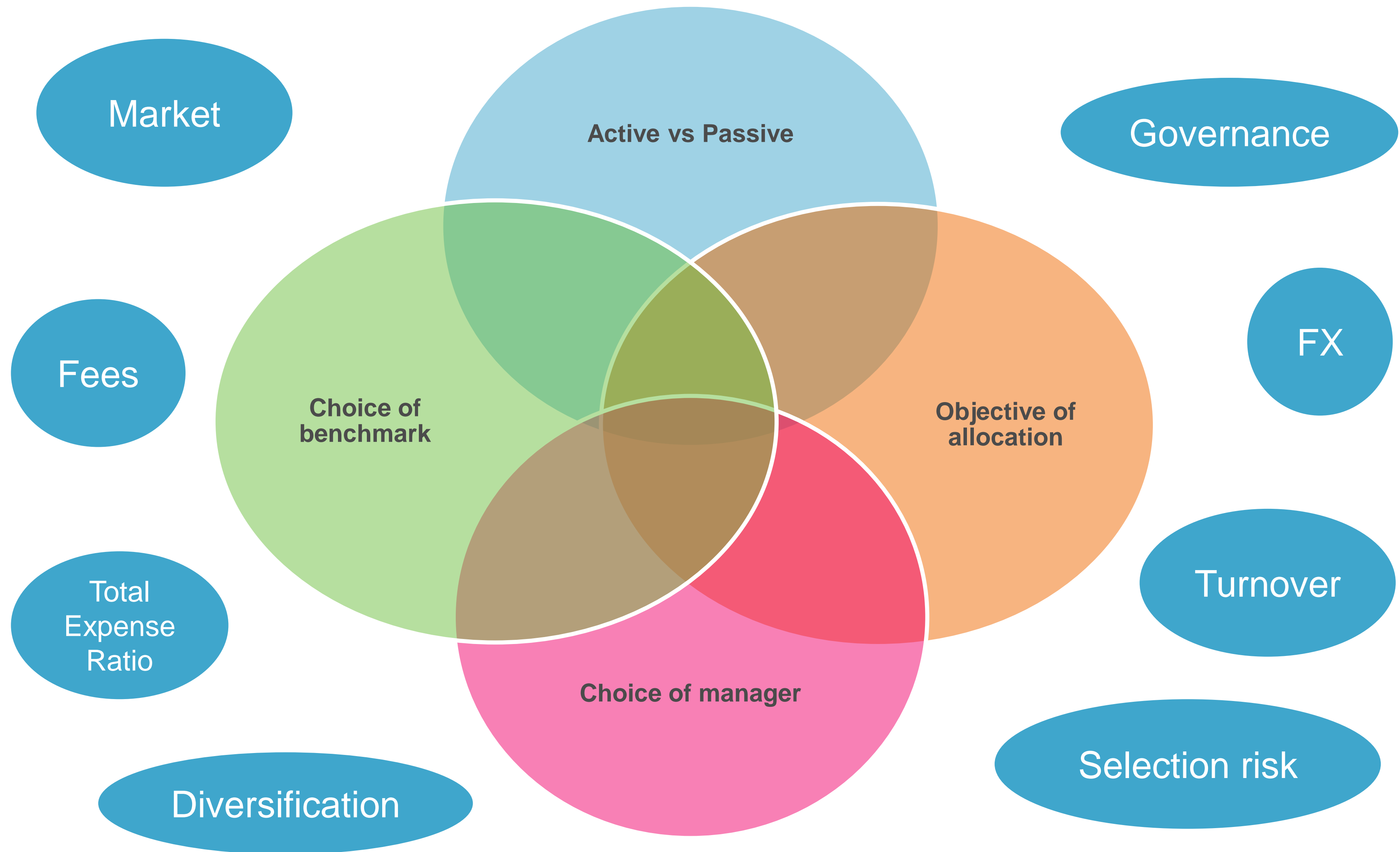
Structural components of equity decisions



Back to basics….

- Generate **a high (enough) return and profile of return**
  - Target should be set in context of Fund needing a real return not an equity return
  - Avoid big drawdown in falling markets
- Maximise **certainty of outcome**
  - Return from equity investment is:

    Equity market +/- benchmark choice +/- active management - fees
  - Only fees are 100% certain

Focus on risk adjusted returns key

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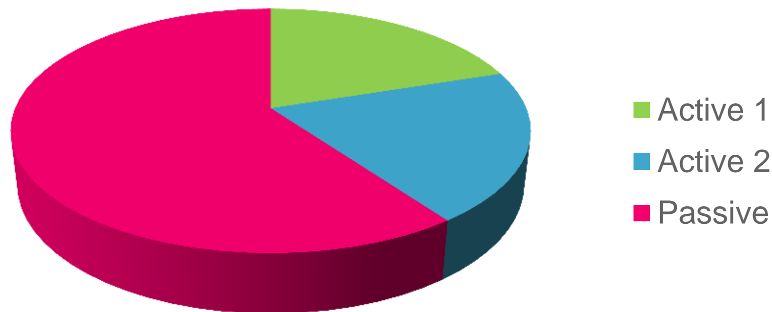
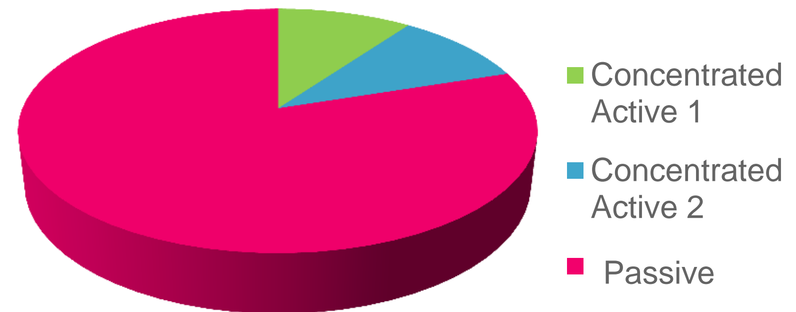
Structuring equity mandates

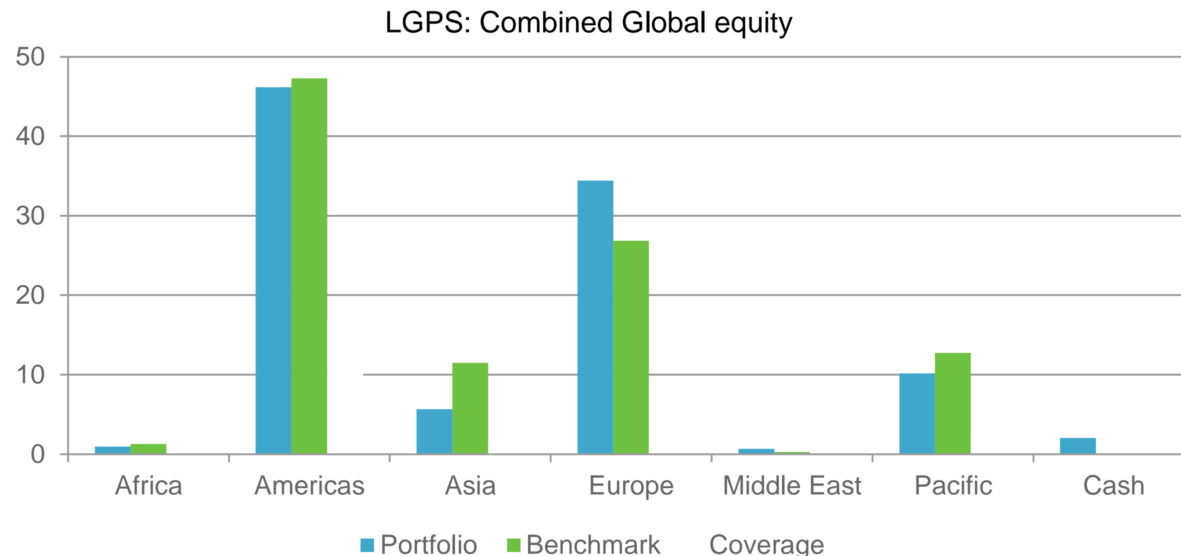




How different are these portfolios?

- If Active managers 1 and 2 run 100 stock portfolios and their concentrated portfolios include only 50 stocks, overall risk may be very similar under structure 1 and structure 2
- Active fees under structure 2 will be more expensive (managers charge per unit of capacity), so overall fees could be just as high as under structure 1
- **Conclusion: compulsion to increase passive allocation may lead to unintended implementation/product changes, but may not achieve required outcome**

Structuring equity mandates



- Analysis is based upon combined portfolio of 5 most commonly used Global equity managers within LGPS
- Global equity managers show limited deviation from regional allocation
- If you hold 50% of global equities in passive mandates and 50% in active mandates, overall match to index is actually 65%.
- **Combining active managers gives you breadth, but also more market coverage**
- **Assessing mandates as active or passive mandates is too a blunt a measure**

Smarter benchmarks

Returns (% p.a.)	5 years to 2009	5 years to 2014	10 years to 2014
FTSE All Share	1.4	17.2	9.0
FTSE All Share 5% cap weight	1.8	17.8	9.5
MSCI AC World	2.6	15.5	8.9
FTSE RAFI All World	4.2	18.3	11.1

Effective Turnover	US	Developed ex US
Market cap 1000	4.2%	6.9%
RAFI 1000	9.2%	12.0%

Source: Research Affiliates, The market impact of index rebalancing

- Smart benchmarks typically include better diversification than market cap, limiting stock specific exposure.
- A common feature of most smart benchmarks and active "smart beta" is rebalancing
- Rebalancing incurs transaction costs, but is shown to add value net of these costs by most academic research
- **Conclusions: transaction costs are not automatically a bad thing. It depends how, why and the extent to which they are incurred.**

Structural components of equity decisions

Key conclusions:

- Define what you want from equities before deciding how to invest
- Compulsion may lead to unintended consequences
- Appropriate use of alternative can be an efficient and cheap source of outperformance
- There is no single right answer– outcomes are uncertain
- Greater certainty and increased chance of higher net returns can be achieved through a combination of:
  - Some more passive management;
  - Alternatives to market cap passive and traditional active management;
  - Upping of governance around use and the selection of managers.

Comply or Explain best value for taxpayers

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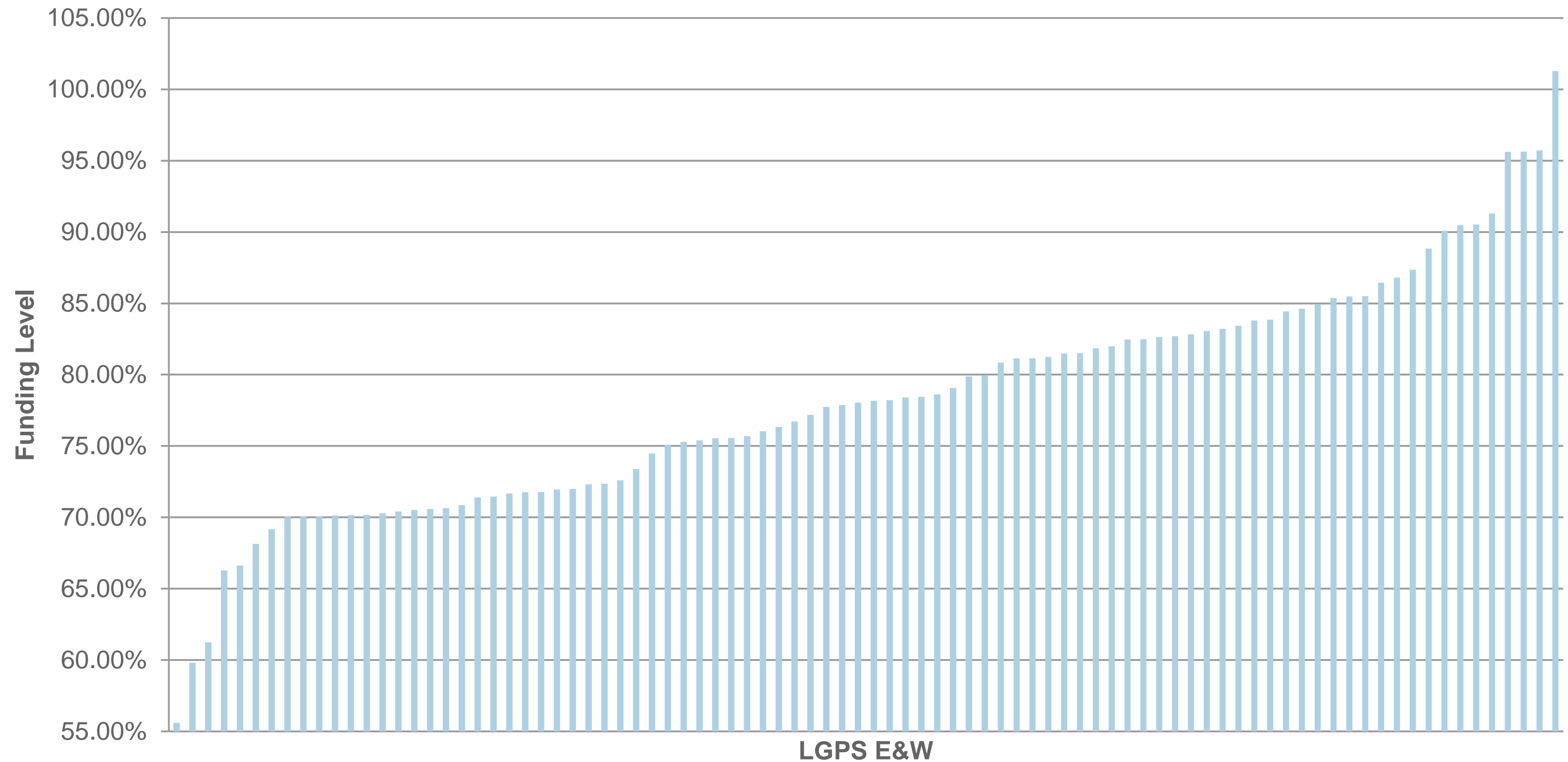
Managing Deficits

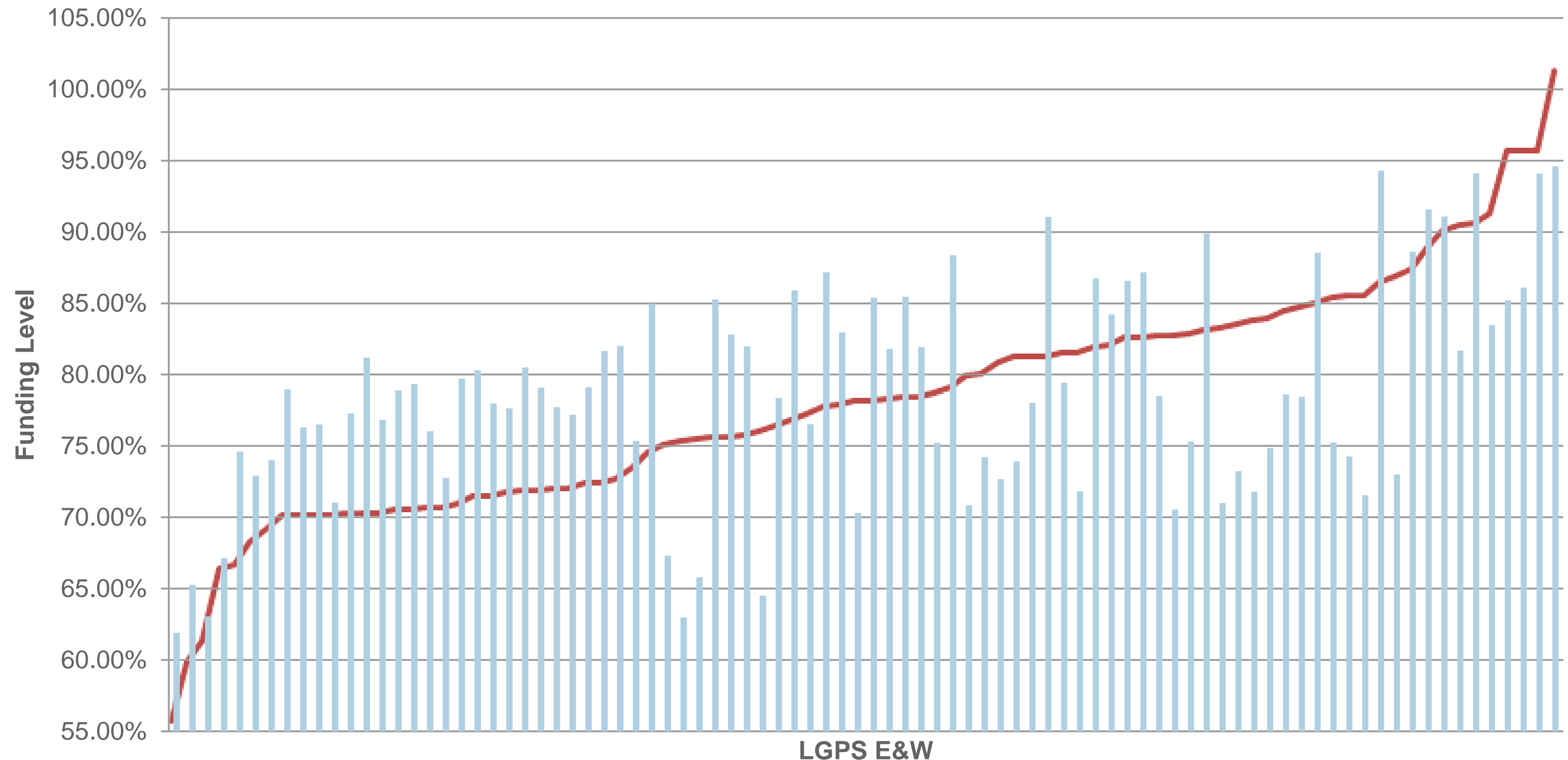
Understand the conditions…

Understanding your position?



Source: All English & Welsh LGPS Funds, values based on 31 March 2013 published valuation data

Understanding your position?



2013 funding levels (rebased to same investment return)

Source: Hymans Robertson; all English & Welsh LGPS Funds, **estimated** values based on 31 March 2013 published valuation data

Basis: HM Treasury standard basis, Net Discount Rate = 0.25% p.a. pre retirement / 3.0% p.a. post retirement

Put in place an appropriate plans

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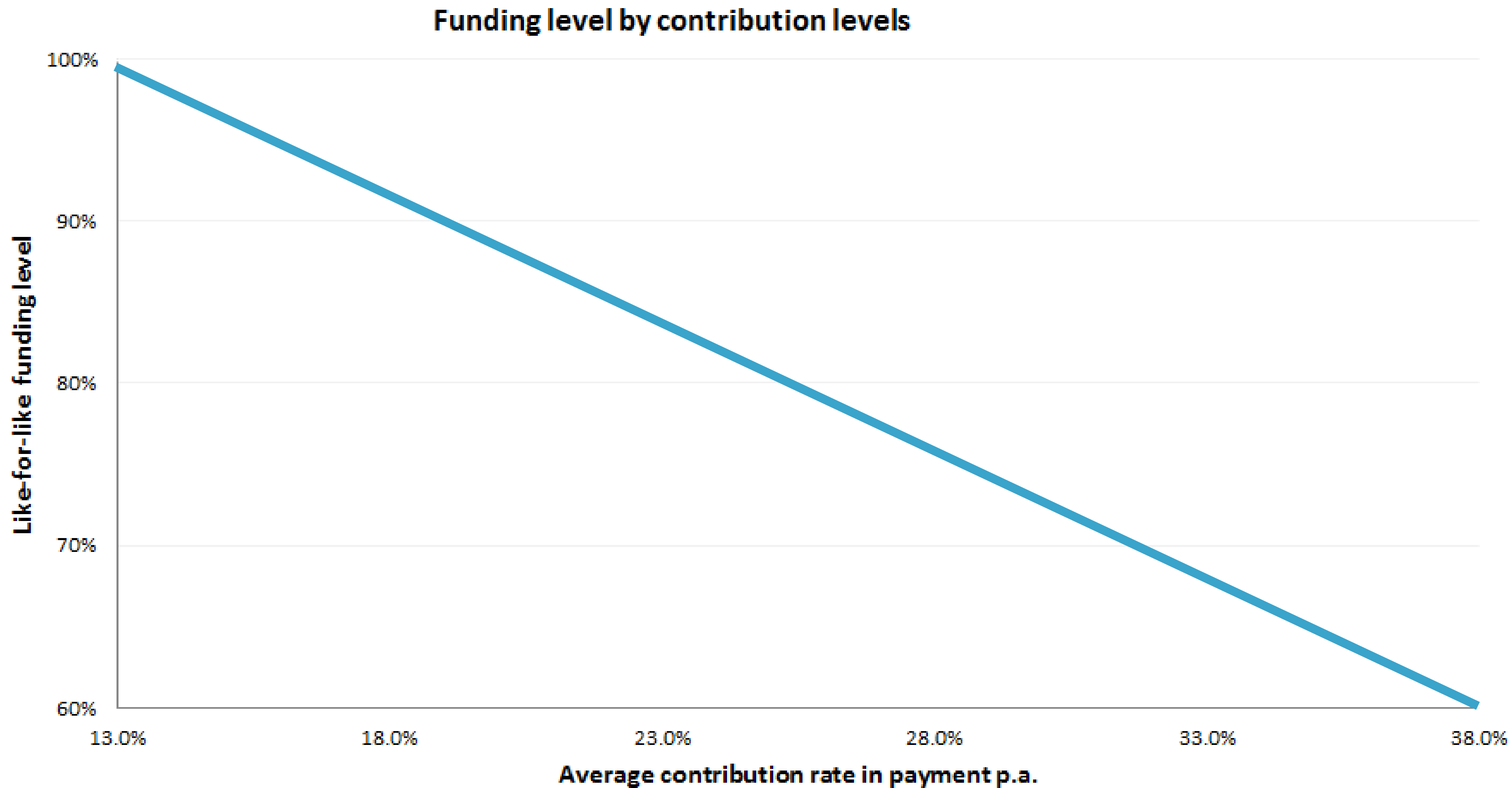
Bigger deficit = Bigger contributions?



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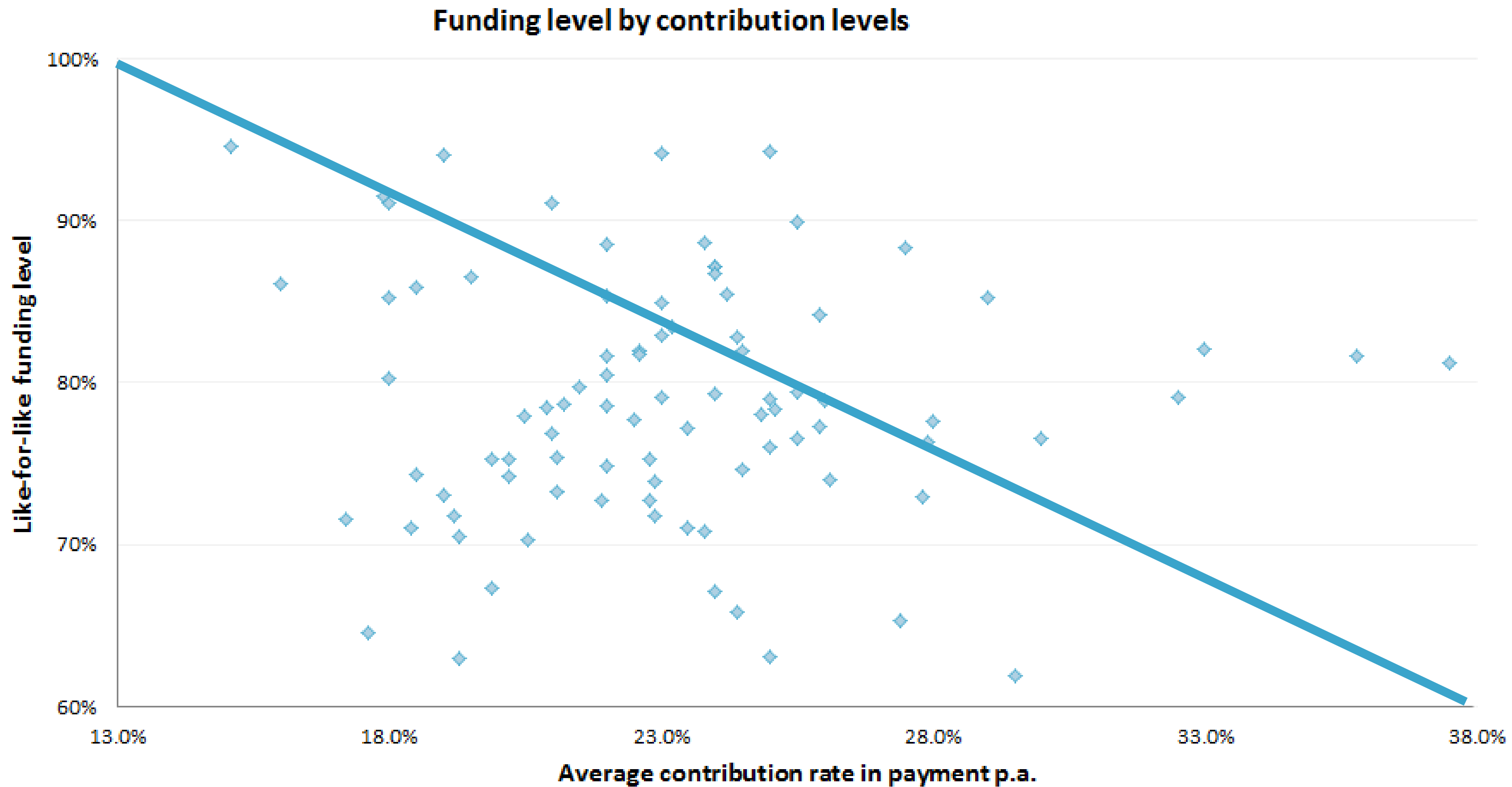
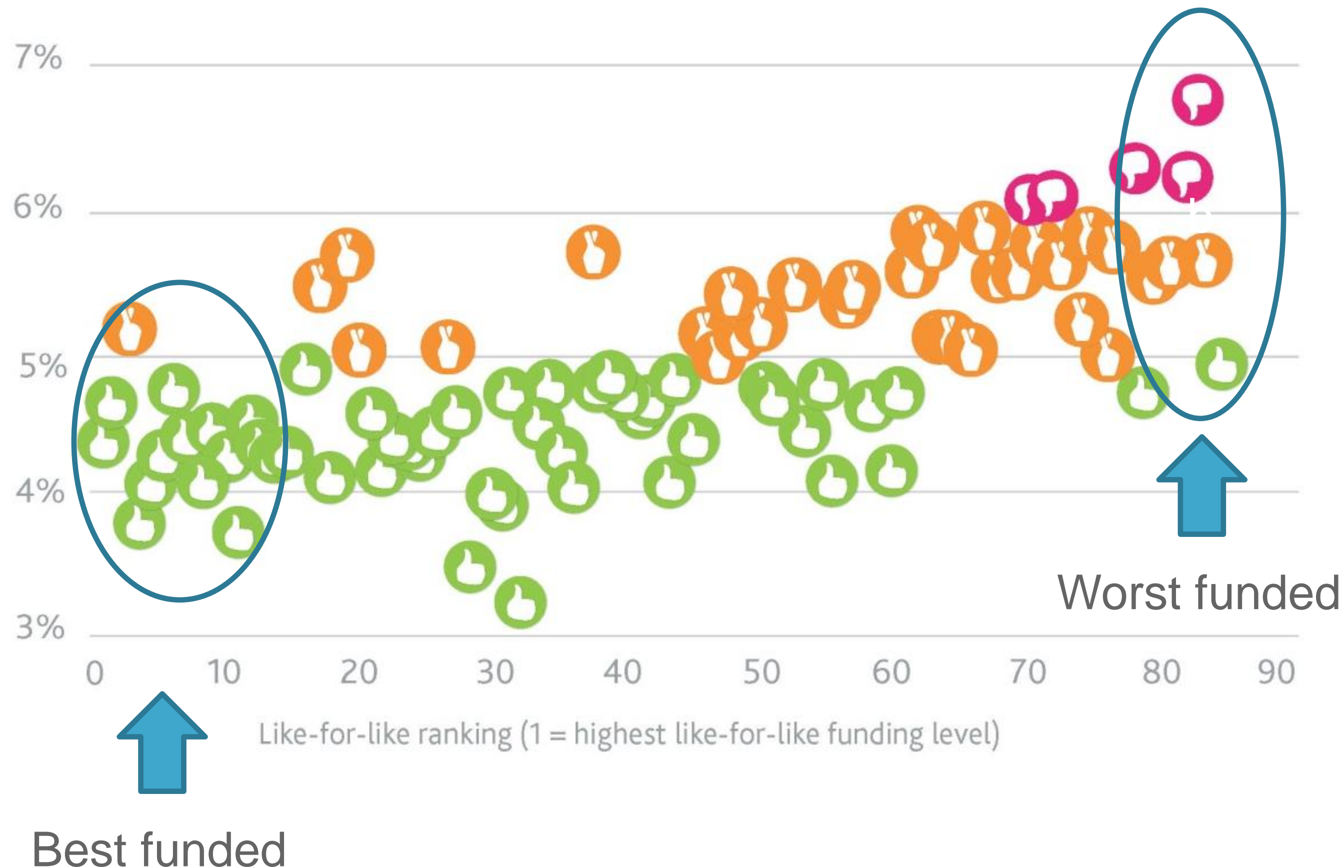
Bigger deficit = Bigger contributions?



Contributions only part of the equation…



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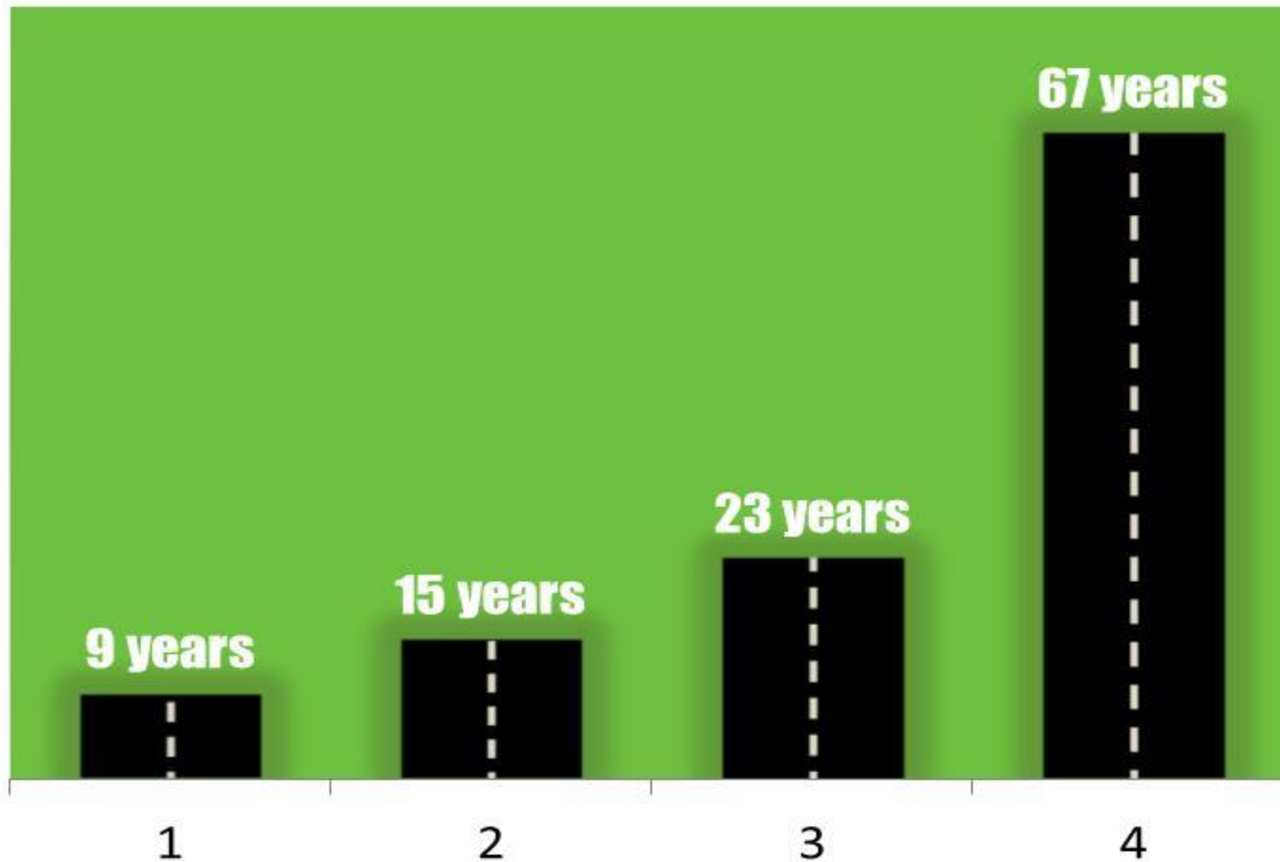
Road to recovery



Average period to pay off deficits by quartile (HMT assumptions and scheduled contributions)

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Scottish valuations

Understand your funding position

+

Understand the risks in your funding plan

Align funding and investment strategies

How structural could help

Reduce costs

+

Improve performance

+

Reduce chance of bad outcomes for individual funds

Reduce chance of higher contributions

Any questions?

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