HYMANS ROBERTSON

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# The future of the LGPS – our beliefs

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The purpose of this briefing is to set out Hymans Robertson's views on some of the key issues under debate following publication of DCLG's further consultation on the future structure of the LGPS and the analytical report that Hymans Robertson were commissioned to produce for DCLG in late 2013. Of course different readers will have different views on the appropriate way forward based on the same data. The purpose of this briefing is to clarify our beliefs and views.

## Our beliefs

Ideas in the current consultation, and others emerging from the Call for Evidence, should be explored because there is potential for significant cost savings and performance improvement that can support the long term aim of an affordable and sustainable LGPS. These are our beliefs:

1. It is worth considering further the idea of Common Investment Vehicles ("CIVs") because they have the potential to achieve benefits of scale and good governance relatively quickly and cost-effectively.

   "Affordability and sustainability must be the key long term aims."

2. There is scope to increase the element of passive investment because some characteristics of active management can be replicated "passively" (or systematically) at significantly lower cost (e.g. using fundamental indexation to create a value bias).

   "Savings of hundreds of millions of pounds are achievable – that's something we can't afford to ignore."

3. Active management does have a role particularly for more complex and less liquid asset classes where in many cases it may be the only option. Active management of listed assets can also be worthwhile, particularly in sectors or regions where there is evidence of an ability to consistently add value.

   "We believe there is a place for active management."

4. We believe that "comply or explain" (for the potential move to more passive) is the best option because it provides the opportunity to retain the stronger elements of performance across the LGPS. We should not throw the baby out with the bath water.

5. Above all we believe that good governance is key, both at local level where responsibility for the significant decisions on investment strategy will remain and in relation to any CIVs that are established. There is some evidence globally[1] (and it makes sense intuitively) that good governance leads to better investment performance

[1] 'Is Bigger Better? Size and Performance in Pension Plan Management', Alexander Dyck, Lukasz Pomorski

## Conditions for success

### CIVs

There are hurdles to overcome to get CIVs up and running not least being reaching a specification that will meet the needs of all of the potential investors.

CIVs should not be pursued blindly if simpler methods of aggregation can be identified (e.g. frameworks, pooled funds designed for the LGPS and hosted by fund managers).

CIVs have the potential to free up Committee time to focus on strategic allocation and implementation where we believe there is scope to add value.

### Passive Management

All elements of a Fund's investment strategy should be consistent with the investment beliefs held by those responsible and accountable for the Fund's performance. Specifically, the extent of passive management should be consistent with the strength of conviction in the ability to identify managers who can consistently outperform.

We expect most investors would benefit from having a material part of their listed assets passively managed, with time focused on identifying return opportunities that have a greater certainty of delivering excess returns than can be expected from active management within listed markets.

### Active Management

The extent of active management must be consistent with investment beliefs and the governance capability.

Passive management should act as a default and active management only be used where there is sufficient conviction that value can be added net of fees and other costs relative to the passive alternative. All managers are vulnerable to periods of poor performance. To reap full benefit of the potential added value from active management good governance is required to avoid "hiring and firing" at the wrong points in the cycle of performance.

### Comply or Explain

A robust regime must be agreed, built on pre-defined criteria and objective metrics (including for example measures of risk-adjusted performance and consistency with individual Fund objectives and governance arrangements).

### Governance

There is a better chance of achieving good governance if there is a strong alignment of interests between the management of the assets and the investment beliefs of those accountable for performance. Internal management can achieve that alignment but scale and depth of resourcing is critical to success. The approach adopted by any individual Fund must take into account its governance resources.

## The Bigger Picture

The Government is focusing on relatively accessible cost savings which if achieved will improve the net investment return for the aggregate LGPS. This improvement will help to chip away at the deficit but will not solve it.

However, we believe that the current deficits pose a significant challenge which must be addressed. We maintain that consistent, realistic measurement of deficits across the LGPS and demonstrating the credibility of funding plans are critical to tackling deficits successfully. Unfortunately there is no magic solution; deficits can only be repaired by a combination of paying more contributions, controlling costs and achieving consistently good investment performance.



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