NewStatesman

Public sector pensions

They make a huge contribution to Britain's infrastructure – and could do more

in association with

Local Authority Pension Fund Forum

So where does all the money go?

By Cllr Kieran Quinn

The Local Government Pension Scheme holds hundreds of billions of pounds in assets in regional funds. How can their influence bring about maximum benefit?

The Local Government Pension Scheme (LGPS) is vast and complex. Across the UK it has about six million members and roughly £250bn of assets. It is run through locally administered regional funds across the UK that carry out the core functions of operating the scheme, collecting contributions, investing, and paying pensions and lump-sum benefits. This collective scale gives us a voice that we have taken efforts to make sure is heard strongly and clearly in the halls of power.

To give an example: I was in conversation on Budget Day with Treasury officials regarding proposals arising from the Budget, with a continued focus on pooling investments in order to improve performance, cut costs and help support investment in UK infrastructure.

This is not as easy as it sounds, but I remain optimistic that it can be achieved. I'm sure I was not the only one to notice a difference in tone from the government this time round. We have moved beyond the language of imposition towards the language of co-operation, with ministers inviting us to come forward with our own proposals.

How the LGPS funds work with government to achieve this goal is one of the most pressing tasks we face. At times like these we must hold on to our fundamental purpose: to provide pension benefits that our members value at a price that ensures taxpayer value and supports local growth.

Reasons for optimism? Managers of local government schemes are looking to boost their cash flows

Many of the critical challenges remain the same. Austerity continues to shrink and fragment the local authority workforce, and the cost of the LGPS has never been so crucial to trying to balance the budgets of scheme employers. Headline writers sometimes brand the LGPS as "town-hall pensions", but the employers and members who take part in the scheme are more complex and wide-ranging, more so than almost any private-sector pension schemes. Some of these non-local-authority employers, most notably housing associations and further education colleges, are starting to come under the kind of financial pressure that local authorities have become used to.

Extremely low interest rates, which increase the value of defined benefit pension schemes' liabilities, are also persisting. The uncertainty in the global economy evidenced by the Chinese stock market's roller-coaster ride in August may keep interest rates low for longer still. We must remember that the LGPS operates on a time horizon of some decades rather than years. We have weathered adverse circumstances before and we will do so again. One way in which we are exploring how to do this is by boost-

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ing our long-term cash flows through investment in UK infrastructure. This is an idea that both we and the government deeply want to see succeed, and the practical steps that we are undertaking to achieve this will be outlined in depth later in this supplement.

We also need to take the opportunity to challenge some of the unhelpful myths around public-sector pensions, such as the idea that they are "gold-plated" when in fact most public-sector pensioners have packages of less than £5,000 per annum. We also need to challenge the idea that public pensions are unsustainable. While it is true that concerns remain over the deficits in the LGPS, the scheme is cash-flow-positive with contributions in exceeding benefits paid. Even with record low interest rates, many LGPS funds remain relatively well funded.

I believe that the reality is less alarming than the doomsayers would have us believe. That does not mean that we can afford to be complacent. There is a real chance through the current reforms to drive even greater efficiency.

We will work vigorously with our members, as long-term asset-owners, to achieve this, and we will also continue our unique shareholder engagement work with businesses on high-profile areas of common interest such as remuneration, carbon management and employment standards.

> We need to challenge unhelpful myths around public-sector pensions

I feel greatly privileged to be involved with the LGPS. My involvement includes chairing the largest LGPS fund, chairing the Local Authority Pension Fund Forum (LAPFF) – the UK's leading collaborative shareholder engagement group – and representing metropolitan local authorities on the LGPS advisory board, which has been created to advise and assist governments on the operation of the scheme.

This supplement contains several articles from experts on local government pensions. They are best positioned to deliver the work we will need to undertake in the future.

The articles are grouped around a common theme: how do we collaborate in order to deliver sustainable long-term value? That is the question that we will be judged on by the government, the wider pensions industry, scheme employers, taxpayers and, most importantly of all, our members. ●

Councillor Kieran Quinn is the chair of the Greater Manchester Pension Fund, chair of the Local Authority Pension Fund Forum and a member of the LGPS advisory board

SHUTTERSTOCK. COVER IMAGE: SHUTTERSTOCK/DESIGN BY LEON PARKS

LGPS reform

Cllr Denise Le Gal

The new ministerial team at the Department for Communities and Local Government will no doubt already be aware of the many opportunities and challenges facing the Local Government Pension Scheme.

The LGPS is vast and complex. As of 31 March 2014, in England and Wales alone it had five million members, more than 10,000 participating employers and nearly £250bn of assets.

The LGPS in England and Wales is delivered via 89 regional funds. Each of these is faced with many challenges – particularly the increased administration needs of the new career-average scheme introduced in 2014, and assisting resource-constrained employers to provide accurate data and to communicate with employees.

Add to this the end of defined-benefits schemes being able to contract out of the State Second Pension in 2016 and the associated requirement for funds to agree millions of individual member records with HM Revenue & Customs, plus the additional National Insurance costs that members and employers alike will incur unless the government introduces measures to mitigate the impact.

As I write, the Chancellor, George Osborne, has just announced the expected further cuts to pensions tax reliefs for high earners, which the LGPS fund should be communicating to members who are likely to be affected.

Funds must also show how they meet the requirements of the Pensions Regulator's code of practice for public-sector pension schemes, which focuses on the quality of administration.

In summary, it has never been so challenging to operate the LGPS – and the 2016 actuarial valuations are just around the corner, with investments suffering because of European economic uncertainty, low-bond yield entrenched and local-authority austerity biting harder than ever.

The description above might read like a tale of woe, but it is dangerous to focus too much on the short term. The LGPS has existed in one form or another for almost 100 years, and has provided financial security for millions of members in their retirement or following adversity. Rather than being a knee-jerk reaction to current events, changes need to be carefully thought out and sustainable.

Ultimately, all LGPS stakeholders are striving to produce a scheme that provides benefits which can support members at a sustainable cost to taxpayers. The cost is largely driven by three points:

1) the benefits that members can expect to receive;

2) the contributions paid by members and employers;

3) the investment returns (net of costs) generated on these contributions.

As life expectancy continues to increase and the footprint of local government becomes smaller, investment returns become more and more important to the sustainability of the scheme.

Among all these changes, something that seems to have been put on the backburner is the creation of fit-for-purpose investment regulations that may help funds improve net investment returns over the long term. These are unlikely to grab headlines, but their impact could be beneficial. The current regulations came into force in 1998. Some changes have been made since, but a fundamental review is overdue.

A balance needs to be struck between principles and detailed rules, and a framework needs to be created that will help support good decision-making in funds.

The current regulations can be too prescriptive. By comparison, private-sector scheme investment regulations are set up on the basis of a prudential framework; these could be adapted to reflect specific LGPS governance arrangements. I believe an appropriate set of high-level investment regulations accompanied by light-touch guidance would be more flexible and beneficial than what we have now.

As with many aspects of the LGPS, this cannot be considered in isolation. In the July Budget, the Chancellor announced that the government will work with LGPS funds to ensure that they pool investments to reduce costs significantly, while maintaining overall investment performance. The investment regulations need to provide funds with the flexibility to work in partnership with others, both inside and outside the LGPS.

This will also help it use its collective scale to help deliver much-needed investment in infrastructure.

In addition, there is the question of who should be responsible for making the key operational decisions within LGPS funds. A positive change already in the LGPS (along with the other public-sector pension schemes) is the creation of a national advisory board to make recommendations to ministers. An important part of the board's 2015/16 plan is looking at ways of improving the governance of LGPS funds and considering the separation between the management and administration of local funds and their host authority.

Three options will be analysed, ranging from ensuring the local government officers who administer the funds sit outside of the local authority's HR and finance functions, to creating pension bodies that are distinct from local authorities and would operate in a similar manner to trust-based DB schemes in the private sector.

These changes can help ensure that LGPS funds remain adequately resourced and not subject to one-size-fits-all cutbacks across the local government workforce. Even the smaller LGPS funds are managing huge amounts (only a handful have assets of less than £500m) and, given the challenges I have mentioned here, LGPS cutbacks are surely a false economy at this time of growing complexity. ●

Councillor Denise Le Gal is the chair of the Surrey County Council Pension Fund, a member of the LAPFF executive and a member of the Local Government Pension Scheme advisory board

Pension funds can collaborate for investment rewards

Susan Martin

In the early summer, one of the most remarkable technological projects of the modern age made a discovery that broadened our view of the universe. Nasa's New Horizons spacecraft, launched nearly a decade ago, travelled around three billion miles to Pluto and beamed back to earth pictures of the farthest reaches of the solar system. This shows the incredible feats we can achieve by working together – ventures that would be unthinkable without collaboration and teamwork.

Why then do we not adopt a similar approach to expertise within the Local Government Pension Scheme, pooling our technical ability to achieve the results we need in order to collaborate?

Collectively, the LGPS is of a remarkable scale – its 89 funds in England and Wales have combined assets of dozens of billions of pounds. However, its level of fragmentation means that it is vulnerable to challenges, especially the smaller funds.

A total of 89 separate funds investing individually results in inefficient administration and communication, as well as more serious challenges that include higher levels of spending on investment fees, an inability to compete for larger investments and reduced access to long-term alternative asset classes that better match pensions liabilities.

A look at recent developments in the infrastructure sphere shows the extent to which the LGPS, and therefore UK pension-holders, are missing out. Time and time again, British financing is overlooked when funding or investment is sought for British projects.

Since November last year, the Qatari sovereign wealth fund has purchased Canary Wharf, a consortium of the Australian infrastructure investor Macquarie Bank and the Spanish group Ferrovial purchased Southampton, Glasgow and Aberdeen airports, and the Norwegian sovereign wealth fund has continued its investment in the Crown Estate. Word has it that the government has courted a string of global investors in recent years. Foreign pension funds were wooed, but not the UK's own LGPS. Infrastructure investments such as these are a win-win.

They provide pension funds with the long-term, liability-matching returns they require to satisfy future pensions payments, and they provide the UK with much-needed capital to support its infrastructure, providing both an economic and a societal return.

Given that – at £250bn – the LGPS is significantly larger than the sovereign wealth funds of Qatar, Dubai or Australia, it is a travesty that we are not able to compete for assets such as these.

The central issue here is scale. To be able to take on such infrastructure projects, individual funds within the LGPS need to work together. Only by collaborating – by sharing our expertise and experience and by pooling our resources – will we be able to compete with sovereign wealth funds from around the globe.

Infrastructure investment requires a high level of expertise and knowledge at board and executive level – something that it is extremely difficult for smaller pension funds to access. Countries such as the Netherlands, Sweden, Canada and Singapore have overcome this difficulty by creating bigger funds over several years; the United Kingdom should seek to mirror this practice.


GETTY IMAGES

Bright lights, missed opportunity: the LGPS was locked out of the Canary Wharf acquisition deal

In the past year, the London Pension Fund Authority (LPFA) has been proud to announce two pioneering agreements with other LGPS funds: the formation of a £10bn asset liability management partnership with Lancashire County Pension Fund (initially named the Lancashire and London Pensions Partnership), and a £500m infrastructure investment programme with Greater Manchester Pension Fund. We believe these agreements point the way to a better, fully funded future for the LGPS.

While these two arrangements are of differing scales and have different goals, each demonstrates that it is possible to think laterally and collaboratively in seeking to create a better LGPS.

The partnerships also support the LPFA's responses to last year's government consultation into the future of the LGPS, which called for more collaboration to realise the benefits of increased scale. We were pleased that this was further echoed by the Chancellor's emergency Budget in July. Minimising investment costs is a critical element of this.

We expect that the economies of scale and cost-saving delivered through improved efficiency will help to achieve lower fee rates for externally managed investments because of larger investment mandates, optimised fee arrangements for direct investments and improved cost management through more sophisticated allocation modelling.

Furthermore, given that, by itself, Lancashire was shortlisted as a buyer of the government's stake in Eurostar and often punches above its weight, greater scale will undoubtedly give us even more heft when bidding for similar assets. The prospects for our collective infrastructure investment are extremely bright.

Our partnership represents 10 per cent of the LGPS in terms of members and employers. We hope to take this further, and to bring together more funds to realise more benefits. It is only through this kind of collaborative, ambitious thinking that we will be able to achieve something truly incredible: eliminating the public pensions deficit and providing a secure, fully funded future for pension-holders. ●

Susan Martin is the chief executive of the London Pension Funds Authority

Manchester aims for commercial return and social impact

Paddy Dowdall

Funds from local government pension schemes can play a vital role in boosting stocks of new homes

Greater Manchester Pension Fund (GMPF) is the largest Local Government Pension Scheme fund in the UK. It has assets of £17.5bn and more than 350,000 members. GMPF has invested in its local area for more than 20 years. The fund's local investment programme has the twin aims of commercial returns and supporting the area.

Commercial returns are defined to be, as a minimum, the return required by the actuary to help deliver low, stable employer contribution rates to employers while maintaining the solvency of the fund. To generate positive local impact, the fund has historically invested in the north-west with a focus on Greater Manchester. This has included direct investment, primarily in the development of commercial property by the fund, and more recently a broader range of investments has been made. The Greater Manchester Property Venture Fund has an allocation of up to 3 per cent of fund value and undertakes property development. Its biggest scheme, a joint venture with Argent, was completed last year: this is a 270,000-square-foot office development in central Manchester, and lettings are going well to high-profile tenants.

There are significant fiduciary and reputational risks in making local investments and it is crucial that the appropriate governance structure and other controls are in place to mitigate these. The GMPF management panel has working groups to lead, oversee and support its operations, all of which meet quarterly. Close attention is given to putting arrangements in place to demonstrate the commerciality of the investment opportunity, including other investors participating on the same terms, external management, external advice and the development of in-house capacity and expertise.

A more recent, important theme in our local property portfolio is the need for housing and the good, risk-adjusted returns that housing can offer a pension fund due to the strong income generation and secure collateral base. The fund has taken part in a venture with Manchester City Council, its first direct involvement in building affordable homes. The aim is to work with other Greater Manchester authorities to increase our investment. The purpose of the investment is to respond to the demand for housing, support regeneration, deliver financial benefits to the council (including a new-homes bonus and enhancement of the council tax base) and, crucially from our perspective, to generate a commercial return. The first project has been successful and we have a high degree of confidence that the investment will deliver on our twin aims.

In this first phase, 240 homes are being built on five sites in Manchester, four of which were owned by Manchester City Council and the other by the Homes and Communities Agency. Of these 240 homes, half are built for sale and half for market rent. The mix between sale and rent was determined by commercial factors. Construction has gone well, as has the sales programme; we have a tenant on a long lease who is also the property manager for the rented homes and responsible for the "landlord's" risks.

Financial viability was determined in aggregate across the five sites and this enabled more homes to be built sooner. There was a mix of sites, with the good sites balancing out more challenging regeneration areas. The fund is also helping other LGPS funds in developing similar projects.

The management panel has been looking to diversify its local investment portfolio while retaining the twin aims. There has also been a debate within the LGPS over the need to increase collaborative working as an alternative to scheme mergers and to compulsory collective investment vehicles.

The fund participated in the Investing for Growth initiative with five other LGPS funds. The aim was for the investments to deliver commercial returns and have a social impact. Due diligence was shared between the participating funds and GMPF invested in opportunities targeting loans to SMEs, property, and social impact bonds.

The next phase, learning from our experience, is to build a local "impact" portfolio. Again, the aim is to build a diversified portfolio investing in funds and co-investments and investing in different parts of the capital structure. The plan includes investments in and loans to SMEs and local infrastructure. GMPF is seeking to work with private-sector partners and other north-west funds in co-investing in some or all of the investments made, adding to and benefiting from an economy of scale. The fund has been an investor in infrastructure funds for many years because of the attraction of long-term cash flows.

To complement this programme and take advantage of opportunities for direct investment and other benefits arising from economies of scale – not least reducing investment management costs and fees – we have entered into a joint venture with LPFA to invest in infrastructure, with each party committing £250m. The joint venture offers the scope for other investors to participate. These sums will be committed within three years if all goes as planned.

GMPF is also looking to collaborate with Funds across the UK in alll capacities and has had constructive dialogue with Strathclyde Pension Fund on ways of working together. It has also given information to the Scottish parliament on its housing investment and hopes to continue to work with all interested parties to promote the model wich combines the provsion of much needed housing with good risk adjusted investment returns for the pension fund.

We are confident that the property, impact and infrastructure investment portfolios that are being developed can deliver on the twin aims, and that the platform is capable of being extended to support collaborative working across the LGPS for these and other asset classes. ●

Paddy Dowdall is the assistant executive director (property and local investments) at Greater Manchester Pension Fund

Despite bubbles and crises, funds deliver well above inflation

Karen Thrumble

The past 20 years have not been an easy time for investors. They have seen the dotcom bubble and its subsequent implosion at the start of the millennium, the 2007-2008 credit crisis and, more recently, the distorting effect of quantitative easing on financial markets. Over this period, the range of investment products available has increased markedly, as has the choice of investment managers. Despite these challenges, local authority pension funds, as measured by the State Street Local Authority Universe (which comprises 85 funds with a total value of $200bn at the end of March 2015) have delivered an impressive aggregate return of 8 per cent per annum – 5 per cent a year above inflation. Such returns are well ahead of that required by schemes' actuarial valuations. In other words, the investment side (the controllable part) of the LGPS pension equation has exceeded expectations.

These returns have been driven by the schemes' investment strategies. Most LGPS funds have remained heavily equity-oriented: the average scheme still invests 60 per cent of its assets in this asset class. Funds have been able to retain this level of commitment – which is well above the typical equity component of corporate schemes – because most have remained cash-flow-positive throughout the period. This is because the schemes have remained open to both new and existing members.

The remainder of the assets has historically been invested in bonds and property. However, in recent years there has been increased investment in alternative asset classes, including private equity (which should provide equity-like returns) as well as diversified growth and absolute-return strategies (which should provide consistent returns – albeit below those of equities – and may reduce some of the volatility associated with equity investing). Some funds have diversified into areas such as infrastructure investment, social housing, forestry, commodities and active currency funds – although these remain at a relatively low level for the LGPS as a whole.

Given the increase in types of investments held, together with the increased specialisation of many of the investment managers employed, funds have increased markedly in complexity over the period. The average fund now has 11 managers – which can create an additional administrative and governance burden, as well as an increase in costs. While adding more managers should improve diversification, some funds may be investing too little in an asset or a manager to make any tangible difference to either its risk or return profile.

Another problem is that funds may be focusing on the wrong areas. Performance, relative to the fund's strategic benchmark, is often afforded a higher level of time and effort than it strictly merits. Only about a tenth of the overall fund return will come from any added-value from active management – yet substantially more time is spent reviewing this part of the scheme return. This focus on relative performance may encourage too much decision-making on a short-term time frame. Managers may not get long enough for their particular style to add value, or they may be appointed on the back of strong recent results. Changing managers, although sometimes necessary, is expensive and the cumulative cost of these changes over time is a major factor in determining why most funds in the LGPS have underperformed – albeit modestly – their strategic benchmarks over the past decade.

Active equity management has had a good run recently: most funds experienced above-index performance in the most recent three-year period. In the longer term, however, after investment management costs have been factored in, the decision to invest actively is less compelling. Passive management is considerably less expensive and removes the risk in manager selection. Just under a quarter of assets under management are currently managed passively through index-tracking funds, while the remainder are managed actively to outperform a benchmark.

The best-performing funds over the longer term are quite a diverse bunch – nearly all of the largest funds have produced better-than-average results. This group usually has good governance structures in place, well-resourced pensions departments and a relatively long tenure of key personnel.

This group also contains most of the internally managed funds, which have performed extremely well at delivering better-than-average results at lower-than-average levels of risk. Internal management has a number of obvious benefits – the investors are genuinely long-term in their approach and not chasing quarterly performance targets. More often than not the funds are well diversified in terms of stock-holdings and the interests of the investment team and the authority are aligned.

It's not just the largest funds that have performed well; some of the best-performing funds over the long term are also the smallest. These funds often have a relatively simple structure due to their size, which means they have delivered strong results in a more volatile manner.

Long-term, straightforward, well-governed – it seems that running a successful fund may not be as complicated as industry experts would have us believe. ●

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All data referenced in this article has been sourced from the State Street Local Authority Universe unless otherwise stated and is at end of March 2015

NewStatesman

Public sector pensions supplement

The Local Authority Pension Fund Forum (LAPFF)

LAPFF has grown in size and influence as the UK's leading collaborative shareholder-engagement group, with 65 public-sector pension fund members representing collective investments of £165bn. Local-authority funds typically account for a significant slice of the ownership of UK-listed companies and, acting together on issues of common concern, they have considerable leverage with companies in which they invest. Given the nature of their liabilities, local-authority funds can adopt an approach to portfolio companies that enables them to invest and grow within a longer time frame. LAPFF's stewardship, through its engagement with company directors, is directed to ensuring that companies have strategies in place to create sustainable value for shareholders.

LAPFF sets challenges . . .

Since the global financial crisis, LAPFF has moved towards a higher-profile approach to engagement. It has led investor criticism of accounting standards that misrepresent the capital position of financial institutions, and continues to challenge standard-setters on the correct application of the "true and fair view" to ensure the critical goal of capital maintenance is met. The forum has also called for scrutiny of accounting firms signing off accounts that don't comply with the law. Too often, collective investor outrage over excessive pay wanes over time; but LAPFF continues to speak out publicly against poor standards and excessive pay at the banks.

. . . but aims to engage in a positive manner

Acting as an owner in the company, the forum aims to align itself with the company against corporate challenges. Particular efforts have been made to engage positively with company directors because, too often, boards hear from investors only when a problem surfaces. LAPFF has moved towards engagement with companies that are owned by the greatest proportion of its members and has increased its attendance at AGMs in recent years, both in Europe and the UK. Such meetings are unique, in that they afford an opportunity to speak to the whole board and can open up opportunities for more productive face-to-face engagement.

How the nature of engagement has changed

Although LAPFF itself is a collective forum, collaborative initiatives with other investors allow the long-term investor to amplify its voice. LAPFF has led a group of European and North American investors in calling for comprehensive transparency and disclosure to be adopted as core principles in reform of the international taxation system. Its engagement with the "Aiming for A" investor coalition to support companies in preparing for a low-carbon future has been considered a game-changer by many in the investment community, after strategic resilience shareholder resolutions co-filed by LAPFF members to BP and Shell AGMs were supported by the boards and achieved more than 98 per cent support at both companies.

Aspects of successful engagement

There appear to be common features of successful engagements. One is collaboration of a group of investors with a common approach to engagement. Another is the nature of the engagement. The BP and Shell engagements were positive, long-term and at both board and below-board level. Where concerns are escalated by filing shareholder resolutions, a second tier of support can be forthcoming with other funds joining to co-file; for the strategic resilience resolutions, this included funds from North America, Europe and Australia. Throw into the mix companies being compared against their peers, and this can catalyse meaningful change.

The future of engagement

Increasingly, LAPFF finds itself working in international alliances and these influences shape the nature of engagement. For many systemic governance concerns, investors and companies will need to forge new ways of working to overcome internal barriers to change. Companies may not only compete with their peers to demonstrate best practice when faced with investor pressure, but may also craft more public alliances with other companies. For example, this year, international CEOs joined to push for carbon-pricing and meaningful agreement at the UN Paris negotiations, leaving some US companies being viewed as outliers.

Whatever the shape of future LGPS arrangements, the step-change improvements LAPFF and other active LAPFs have achieved through company engagement show that this activity is greatly valued. Ongoing challenges will remain, such as improving the ability to vote in pooled funds or through passive indices. Now is not the time for investors to step away from their commitment to robust and responsible engagement.

More information on the LAPFF can be found at **www.lapfforum.org**. The forum is supported in its work by PIRC, its research and engagement partner: **www.pirc.co.uk**.

Local Authority Pension Fund Forum