centro
transforming public transport

Victoria Edwards
Department for Communities and Local Government
Zone 5/G6 Eland House
Bressenden Place
LONDON SW1E 5DU

Sent by email to: LGPSReform@communities.gsi.gov.uk

11th July 2014

Dear Victoria

Consultation on the Local Government Pension Scheme : Opportunities for collaboration, cost savings and efficiencies

Further to the consultation issued on 1 May 2014 seeking feedback on the future of the Local Government Pension Scheme (LGPS), please find attached as requested, responses to the specific questions posed.

The attached response is on behalf of the West Midlands Integrated Transport Authority Pension Fund (WMITA), which is administered under LGPS regulations by West Midlands Pension Fund. At 31st March 2014, it had assets valued at £430 million and it provides pension services to over 5,000 current and former transport authority employees.

Whilst the focus of the consultation is on the very important issues of collaboration, cost savings and efficiencies, it is essential not to lose sight of the primary objectives of last year's call for evidence on the structural reform of the LGPS, namely the reduction of fund deficits and the improvement of investment returns. The reduction of fund deficits in particular remains by far the most important issue facing the LGPS. In this context, the achievement of cost savings and efficiencies is just one of a number of components in addressing the primary objectives.

Centro, Centro House,
16 Summer Lane, Birmingham, B19 3SD
Tel: 0121 200 2787 Fax: 0121 214 7010
www.centro.org.uk

WMITA agrees that the deployment of passive investment in developed market listed equities and gilts makes sense but does not favour its mandatory use, favouring instead a 'comply or explain' approach. WMITA is fully supportive of collaborative ventures involving LGPS funds and is open minded about the use of CIVs but would not support their mandatory use and would highlight the potential complexities in setting up such vehicles, particularly in alternative investments. We emphasise the attractions and advantages of other forms of collaboration, including National LGPS Frameworks. We note also that internal LGPS investment management arrangements deliver good investment performance cost effectively, as evidenced in Hymans Robertson's report.

I hope that this response is a useful contribution to the consultation. Should you wish to discuss further any of the points covered in the attached response, please do not hesitate to contact me.

Yours sincerely

James Aspinall
Treasurer to the Integrated Transport Authority

Centro, Centro House,
16 Summer Lane, Birmingham, B19 3SD
Tel: 0121 200 2787 Fax: 0121 214 7010
www.centro.org.uk

centro
transforming public transport

RESPONSE TO DCLG CONSULTATION RE LGPS - MAY 2014

Q1. Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments? Please explain and evidence your view.

The use of common investment vehicles (CIVs) could allow some funds, especially smaller ones, to achieve economies of scale and deliver savings. However, it should not be assumed that this will be the case in all circumstances. Specifically, WMITA obtains very cost effective passive index tracking portfolio management services arranged through West Midlands Pension Fund and it is not obvious from the findings of the Hymans Robertson report that we would be able to secure a more cost effective service in this area via a CIV. We note also that in Chapter 2 of the Hymans Robertson report on LGPS structure analysis, it is mentioned that internally managed funds have delivered good investment performance cost effectively (drawing on research provided by CEM).

WMITA recognises the potential advantages of scale for the passive management of highly liquid investments such as quoted equities in developed markets and gilts (both conventional and index linked). In other areas, whilst some scale and resources are essential, the deployment and management of capital needs to be handled effectively, especially in less liquid assets and strategies. Scale per se does not necessarily lead to optimal investment outcomes.

Q2. Do you agree with the proposal to keep decisions about asset allocation with the local authorities ?

Yes. WMITA supports the key principle of local accountability. If other important decisions are made locally, it makes sense that asset allocation decisions are made locally, too.

Decisions on asset allocation need to be made in the context of fund objectives, cashflows, liabilities, contribution rates, deficits, deficit recovery plans, portfolio risks, employer covenant strength and other relevant factors.

Asset allocation decisions are by far the most important determinants of long term investment performance and risk – far more so than, say, the decision to appoint fund manager A or fund manager B for a given mandate.

If asset allocation decisions are made locally, it makes sense for decisions regarding portfolio objectives and portfolio construction to be made locally too, as these are crucial as well as integral to the overall investment process. These would include decisions on how much to invest passively and how much to invest actively in liquid assets. They would also include making decisions on whether or not to invest in alternative assets and if so, for what reason (s) and in which areas.

Centro, Centro House,
16 Summer Lane, Birmingham, B19 3SD
Tel: 0121 200 2787 Fax: 0121 214 7010
www.centro.org.uk

WMITA recognises the importance of effective governance and appropriate resourcing wherever decisions are made. It has a dedicated trustee training programme for all committee members and is supported by West Midlands Pension Fund's investment division and external advisers. Intuitively it makes sense that good governance leads to better outcomes and there is some evidence (for example in Dyck and Pomorski's paper 'Is bigger better? Size and performance in Pension Plan Management') that this is so, too.

Q3. How many common investment vehicles should be established and which asset classes do you think should be represented in each of the listed asset and alternative common investment vehicles ?

WMITA is very supportive of LGPS collaboration to deliver good outcomes cost effectively. At this stage, we open minded about the use of CIVs but we would not support their mandatory use. Nor would we wish to be prescriptive regarding the specific number of CIVs. We agree that funds of funds are expensive and do not support their extensive use.

When considering how many CIVs are established, it is important to recognise that in actively managed and less liquid areas, big is not necessarily better. CIVs should be sized and structured so that capacity is managed carefully to ensure that investment objectives are delivered effectively.

Whilst the case for investing in alternative investments via a CIV or CIVs is intuitively strong, it is a more complex area than conventional liquid assets and the practical issues associated with successfully setting up such a vehicle should not be underestimated. For incoming investors, there would need to be clarity regarding investment objectives and terms. The liquidity and diversification characteristics would need to be considered, too.

In addition or as an alternative to investing via CIVs, consideration should be given also to other methods of collaboration. WMITA highlights the National LGPS Frameworks, which seek to reduce procurement costs and timescales as well as delivering cost effective solutions. Greater use of pooled funds specifically designed for LGPS funds and hosted by investment managers may also deliver meaningful cost savings quickly and simply. We believe it very likely that greater use of both options could deliver results more quickly than setting up CIVs.

Q4. What type of common investment vehicle do you believe would offer the most beneficial structure? What governance arrangements should be established?

So far as CIVs specifically are concerned, the following characteristics are crucial –

*Robust governance structure and arrangements (covered later in this section)
*Appropriate for professional investors to pool assets
*Capable of supporting a range of ring fenced sub funds

Centro, Centro House,
16 Summer Lane, Birmingham, B19 3SD
Tel: 0121 200 2787 Fax: 0121 214 7010
www.centro.org.uk

*Flexible for different investment strategies
*Cost efficient
*Manageable capital considerations
*Appropriately regulated
*Assets held by an appropriate custodian
*Able to be used as part of a master/feeder arrangement
*Capable of offering a range of liquidity options for investors
*Tax efficient with regard to both capital gains and other taxes
*Access to dual tax treaties so that withholding taxes are minimised
*Cost and tax efficient in specie transfer of assets into the vehicle

In this regard, regulated co-ownership tax transparent pension fund vehicles could be particularly appropriate. The CIV currently being set up by certain London Boroughs could be regarded as a valuable pilot. It may be prudent to defer the setting up of any new CIVs until after the London CIV is successfully up and running in order to benefit fully from the experience of creating this vehicle.

WMITA suggests that the associated governance arrangements should be robust and kept as simple and straight forward as possible. Key areas of focus should be on improving net returns (with due regard to risk), reducing / controlling costs, addressing conflicts of interest and facilitating decision making for the funds that invest in any CIVs.

In order to strengthen governance and oversight, it is suggested that any CIV should have an investment committee with membership drawn from fund officers and members with support from professional advisers.

Q5. In the light of the evidence on the relative costs and benefits of active and passive management, including Hymans Robertson's evidence on aggregate performance, which of the options set out above offers best value for taxpayers, Scheme members and employers?

On the issue of passive investment, with 54% of its investment assets invested passively, WMITA believes that passive index tracking has a crucial role to play in the effective management of developed market listed equities and gilts (conventional and index linked). Passive index tracking management in these areas is an effective, low cost way of deploying substantial amounts of capital.

At the same time, WMITA favours targeted active fund management in listed assets. In order to improve portfolio diversification and control portfolio volatility, WMITA invests in actively managed Diversified Growth Funds, which have met their investment objectives since inception. It is not currently feasible to invest in this way via passive investment management arrangements.

In some areas, we think that the deployment of passive index tracking is sub optimal. A passively managed allocation to corporate bonds tracking a market capitalisation benchmark would structurally expose investors to the more indebted and therefore intrinsically higher risk issuers. We do not believe that this is an effective way of

Centro, Centro House,
16 Summer Lane, Birmingham, B19 3SD
Tel: 0121 200 2787 Fax: 0121 214 7010
www.centro.org.uk

investing in this asset class and accordingly, WMITA's entire corporate bond fund holdings (accounting for 10% of investment assets) are invested actively.

WMITA firmly believes that both passive and active management options (including options that could be categorised as either, for instance 'smart beta') should be considered in the process of setting objectives for portfolios both individual and consolidated. Issues to consider include not only returns, costs and value for money (all crucially important) but also portfolio volatility, risks (for instance concentration risks) and overall portfolio construction.

Of the four options presented, WMITA favours the 'comply or explain' one as offering potentially the best value, as long as the process for so doing takes proper account of funds' specific investment objectives and genuinely assesses long term performance (recognising that over short term timescales, the most successful active managers can and do underperform).

We fully accept that rigour is needed in determining the decision to invest passively or actively in listed assets but do not believe that compulsion to invest passively (in whole or part) would be a solution to improve investment performance cost effectively. Accordingly, we do not favour the first two options proposed. The fourth option, which amounts to the status quo, is in our view insufficiently rigorous.

Summary

WMITA firmly supports appropriate measures to improve the efficiency and cost effectiveness of the LGPS. So far as the consultation is concerned, we consider that:

- Decisions regarding asset allocation and portfolio objectives should be made locally;

- All forms of collaboration should be actively explored. There may be a role for a CIV or CIVs (ie in alternative investments) but we would not support the mandatory use of CIVs and the potential complexities associated in setting up such a vehicle should not be underestimated. We note also that LGPS internal investment management arrangements deliver good investment performance cost effectively;

- The 'comply or explain' option would be best so far as passive investment management is concerned. WMITA believes that passive investment management has a crucial role to play in listed assets, but in conjunction with targeted active investment management. WMITA does not favour compulsion to invest passively (in whole or part) as an optimal solution.

11th July 2014

Centro, Centro House,
16 Summer Lane, Birmingham, B19 3SD
Tel: 0121 200 2787 Fax: 0121 214 7010
www.centro.org.uk