LGPS consider a wider spectrum of investment solutions

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"The biggest drivers of risk in most LGPS are interest rates and inflation. Typically, these risks will account for some two-thirds of the variability in contributions, and are often considerably higher than longevity or equity risk."

At Legal & General Investment Management (LGIM), we're increasingly finding that Local Government Pension Scheme (LGPS) are considering their investments holistically – cutting across traditional investment products and focusing on the broader picture. In today's complex and challenging market, it is more important than ever for schemes to improve their risk/ return profile and reduce unrewarded risk (ie risks with no potential for returns). Often it's the easy-to-understand and cost effective solutions that set the LGPS standard for meeting investment objectives.

Liability-aware investing: not if, but when

Local government pension schemes are increasingly providing pensions to an older workforce, with fewer active members funding contributions. Conscious that it is the employer that foots the bill when the funding level falls, many funds have evolved their focus from looking at traditional growth assets to more liability-aware strategies.

Interest rate and inflation changes are the greatest sources of funding level volatility for most LGPS. And something as simple as a change in asset allocation could help schemes to reduce these unrewarded risks. When liability movements (caused by interest rates and inflation) are matched or mirrored by asset movements, significant swings and volatility in funding levels are reduced. Liability-aware investing does not mean reducing allocations to growth assets, lowering expectations on future investment returns, increasing cost to employers or investing in expensive and opaque instruments.

Many of the schemes we talk to, want to maintain their allocation to growth strategies whilst making better use of existing bond assets via simple-to-access pooled funds. By restructuring existing gilt and index-linked gilt assets, local authorities can make these assets go much further; reducing unrewarded interest rate and inflation risks and the variability of contribution requirements over the long term. In addition, buy and maintain credit strategies have come to the fore as a possible solution to fully or partially match future liability cashflows. The difference is that buy and maintain strategies have the potential to deliver additional returns over and above a purely UK gilt-based approach. As buy and maintain credit strategies generally aren't concerned with rebalancing to an index, they also tend to see lower turnover than a traditional credit portfolio, and hence lower trading costs.

Ultimately, liability-aware investing aims to provide a smoother ride, with fewer nasty surprises along the way.

Index funds that do more than track the market

Pension schemes have long been attracted to index funds: they provide a relatively simple, cost-effective way to access market returns. But investors are increasingly aware of the disparity in manager approaches to index funds.

As well as the replication process, some managers undertake index changes, rights issues or stock lending in different ways – some benefit clients more than others. For instance, index changes can be effected simply, but not efficiently, by just buying and selling the relevant stocks on the day of an index change.

Our experience shows that careful planning and setting a strategy for each change has the potential to deliver considerable value for investors. Introducing small tolerances and spreading transactions over a period around the change can often result in a better average price being achieved for the fund.

All gains made through index management are passed on to our clients in LGIM – whether it's produced from stock lending or more efficient implementation. It's your holding, it's your gain.

Smart beta, smarter return

One of the great attractions of active management is that it looks beyond a simple index weight and seeks measures of worth or value. Increasingly however, LGPS can access these attributes in a cost-effective manner, through the use of smart beta, or factor investing funds.

We recognised that smart beta (also known as alternatively weighted or fundamentally weighted funds) could be attractive to LGPS because they provide focus on factors deemed most important in driving performance. It can help LGPS implement an active viewpoint whilst maintaining many of the advantages of a tracker fund approach such as lower costs, lower governance and greater transparency.

Fundamental factors such as value, size, momentum, volatility and dividends are widely accepted as key drivers of return. Importantly, these factors are wide enough to be investable on an institutional scale, and this increased accessibility is fuelling demand for factor investing – visible through the increasing popularity of factor indices.

At a basic level, smart beta indices provide a relevant benchmark to measure how and where an active manager adds value. But used effectively as the basis for transparent, rules-based investment exposure, smart beta could herald a real change in the potential allocations of local authorities and how you access excess returns.

Real change is best achieved through active ownership

For some, the misconception still exists that effective corporate governance can only be achieved in active funds. At LGIM, we see things differently.

As one of the largest index asset managers in the UK, we recognise, respect and use the responsibility afforded us by our clients. We don't consider our index-tracking funds as passively managed. Instead, we use our scale and influence actively to bring about real, positive and long-term change across the entire market, globally.

As companies realise that we are long-term investors who are not interested in enforcing measures designed to make a quick buck, management are more willing to engage and adopt our suggestions on governance standards. We focus both on individual company engagement and on making whole market standard changes. Indeed, the majority of our clients no longer believe governance measures should be applied through specific funds only. They are more interested in how companies' activities can impact their mainstream investment portfolios and how we manage such impacts on their behalf.

In the government-backed Kay Review, one of the key recommendations was for asset managers to stop focusing on generating short-term single stock outperformance and start focusing on long-term improvement for all market participants. In other words, enhancing whole market returns. It's an agenda we have been supporting for many years.

We have worked to push through new rules on auditor tenure and non-audit fees resulting in improved transparency for all investors. On board effectiveness, our consistent and clear message, that boards with a diverse range of experience and knowledge will outperform those with uniform backgrounds, has brought about real change in UK boardrooms.

The corporate world will not change overnight but we are encouraged by the significant improvements seen in board diversity, director pay and companies' willingness to engage. We believe sustainable, long-term growth is best achieved by ensuring that certain standards of governance are adopted in all companies. Active ownership and engagement in index fund management has proved to bring positive changes and added meaningful long-term financial value to our clients' investments.

In the long run, our active ownership should result in more stable and consistently better returns for you, the shareholder.

At LGIM, we believe that the breadth of our experience results in investment solutions that meet the specific challenges facing the local authority sector. We couple this with our award-winning client service and clear focus on meeting clients' needs. This combination has helped us to become the largest manager of public sector mandates in the UK.