Scale, structure and stewardship: the future of LGPS investing

James Sparshott
Head of Local Authorities
Legal & General Investment Management

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Local authority funds will be carrying out their triennial valuations in 2016, and are currently dealing with more complexity than ever: the investment environment is more uncertain due to concerns over the direction of interest rates in the US and UK, the potential for a prolonged slowdown in China, and the impact of falling oil and commodity prices. Furthermore, the structure and nature of local government pension investment is at a crossroads, with the ambition to get better outcomes for the LGPS funds by pooling assets and achieving economies of scale through the sharing of resources and capabilities and the use of collective bargaining power.

Improving investment outcomes

The government has laid out four clear criteria for assessing new pooling arrangements:

1. Achieve benefits of scale – by pooling assets with other LGPS funds to realise scale benefits

2. Strong governance and decision making – ensuring that assets are managed in line with the stated investment strategy, explaining how external scrutiny will be used and how social and corporate governance policies will be handled

3. Reduced costs and excellent value for money – making sure that both explicit and hidden investment costs are reported and controlled, aiming to reduce these while maintaining overall investment performance

4. Improved capacity to invest in infrastructure – very few funds invest in infrastructure at present and the government believes that pooling may help increase exposure to this asset class

The new UK Authorised Contractual Scheme (ACS) fund structure is the potential future of LGPS investing. Many funds currently invest through life fund structures, and it is worth examining the pros and cons of each when looking at the cost of investment. We break these costs down into running costs for the structures and transaction costs for those wanting to use them.

Scale, not structure, is key

There are various elements to running costs. The investment management fee is the obvious starting point, but this would be the same whether a fund is using the ACS or life fund structure. However, a number of fund costs such as administration or custody benefit from scale – as these tend to be a fixed cost across all the assets in the fund. If there are more assets in the fund, then the cost per unit will be lower.

We find a similar story with transaction costs for LGPS funds. These can be reduced or even eliminated through crossing – matching buyers and sellers so that units are transferred without the underlying securities actually having to be bought or sold and hence incurring dealing fees. Naturally, as asset pools and the number of investors in them grow, the opportunity for transaction cost savings will increase as there are more transactions that can be matched. Not all investment managers have yet launched an ACS structure, and those that have generally did so in the last year or so, meaning that ACS assets are probably still smaller than life fund equivalents. This means that in the short term at least, transaction costs under an ACS are likely to be higher than a life fund.

Cost isn't everything

As costs are often more quantifiable, it is easy to overlook other factors that have a significant impact on your investment outcome. The primary goal for all index managers is to deliver the index return to their clients. While the headline fee is an obvious detractor from returns, it is also important to look at the investment process used to see if this has the potential to enhance or damage returns. Many investors tend to consider investment process only when looking at active funds, but an overly mechanical index fund management process has the capacity to hurt your returns. In addition, it is important to see whether the proceeds of activities such as stock lending accrue to you, rather than being shared with the manager. It's your holding, it's your gain.

Furthermore, while we believe that a reduction in costs can help improve funding levels, we recognise that market movements usually have a greater impact. It may be useful to use some of the time and money saved from the pooling of assets to improve asset allocation and risk management. Improving asset allocation can make a material difference to overall returns – studies have shown that the asset allocation decision typically accounts for over 90% of the variation in portfolio returns.[1] We all recognise that different asset classes perform better at different points in a traditional market cycle and so focusing on being in the right assets and markets may be better for overall outcomes.

Achieving corporate change 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. Our experience is that local authority clients have been at the forefront of pushing for greater engagement with companies, whether ownership is through active or index funds.

We believe, as do most LGPS funds, that better governance isn't something that should be restricted to specialist ESG or ethical funds, but something that should be applied to all investment portfolios. We believe that improving governance, environmental or social performance of the underlying companies is not just an ethical or "non-financial" consideration. Better governance leads to better company performance.

It is worth investigating what corporate governance means to the managers you use. Are they using influence to bring about real, positive and long-term change across the entire market? Is there evidence that management and regulators are willing to engage with and adopt suggestions on governance standards?

Bringing it together

In effect, the new government objectives all point towards greater efficiency – whether explicitly through lower costs or implicitly through better governance and decision making. Harnessing the opportunities provided by these changes will obviously take some time, but should ultimately lead to a healthier LGPS for members.

1. G Brinson, LR Hood and DP Beebower, 'Determinants of Portfolio Performance', 1986