Local Government Pension Scheme: Opportunities for Collaboration, Cost Savings and Efficiencies

1. Introduction

1.1.1. Cumbria LGPS is delighted to have the opportunity to respond to the consultation: *"Opportunities for collaboration, cost savings and efficiencies issued by the Department of Communities and Local Government".*

1.1.2. Cumbria LGPS is Scheme serving circa 50,000 members (13.5% of the adult population of the county) across 111 employers, with almost £1.8bn of investment assets and with a funding position of 85% as of June 2014 (78% March 2013).

1.1.3. This response sets out our consideration of the questions asked and concludes in relation to the creation of CIVs that for at least some asset classes there may be a case to be made and as such further investigation is warranted. However, this consideration must be widened to consider investigation of other alternatives to deliver fee savings, through mechanism's that support local decision making and allow those consistently good performing Schemes to build on and share the governance and investment processes already proving to deliver results.

1.1.4. As to the questions on passive management, Cumbria LGPS does not believe there is a good case for across the board imposition of pure passive management. However it does consider that there is a place for enhanced passive and/or targeted increases in pure passive and would therefore support a 'comply or explain' approach but with the backing of some form of regulatory conditions for permitting continued use of unlimited active management

1.1.5. We are however concerned that the consultation focuses on the creation of CIV's and the extended use of passive purely from the perspective of achieving fee savings. The correction question to which we should be seeking an answer is; how do we help the consistently poorer performer's achieve above benchmark returns net of fees and thereby offer a real cost saving to local taxpayers, Scheme members and employers in the longer term. The focus should be on better – not cheaper.

1.1.6. Cumbria LGPS would welcome the opportunity to participate in this further debate on the matter as we consider Administering authorities need all available tools at their disposal in order to meet the challenges of membership changes and managing deficits at both a whole fund and individual employer level. This includes fit for purpose investment regulations, encouragement and support to create strong governance arrangements and the ability to make key decisions at the local level.

2. RESPONSE TO QUESTIONS

Q1a - Would CIVs allow funds to achieve economies of scale?

2.1.1. On the limited and mainly theoretical evidence as currently presented, Cumbria LGPS believe that - if the object is reduction of fees through economies of scale - then the creation of CIVs is potentially one way, and we stress only one way, of achieving this but that they will be appropriate for only a limited number of asset classes and for a limited number of Funds. By their very nature CIV's are a "one size fits all" and the lowest common denominator and will represent for the more sophisticated and better managed Schemes something of a compromise rather than being able to deliver Scheme specific requirements'. Effectively we may drag all down to mediocre performance rather than looking to pull poor performing Schemes up to the top.

2.1.2. However, we do have concerns regarding the validity of some of the assumptions made in the "Hymans Report" and the lack of information in other crucial areas, notably:-

- Inconsistent performance comparison: comparing LGPS performance net of transaction costs to a benchmark that does not include the impact of transaction costs (impact of circa 10bps pa) See attached evidence from ERPF
- Ignores the impact of risk: the analysis does not consider risk adjusted returns a basic tenet of performance measurement.
- Includes assets already managed on a passive basis: 44% of equities and bonds are already managed on a passive basis and as such should be excluded when assessing relative performance of active management.
- Focuses on the LGPS in aggregate: a number of LGPS's have generated higher absolute and risk adjusted returns net of all fees on a consistent basis over

the longer term but the reason for this outperformance has not been considered. Cumbria is one such Fund where we have a very low risk appetite (supported by WM data) and yet have still managed to achieve longer term out performance net of fees for the assets managed passively (over the last 5 years this has delivered an excess performance net of fees of over £15m).

- Fails to define passive management: there are various forms of passive management with differing risk profiles and fees structures and varying levels of transaction costs.
- How does a CIV allow for local decision making? As the Funds outside the limited number there would be on any management board have no discretion as to the managers selected for inclusion in the CIV local decision making is necessarily constrained.

2.1.3. We would also add that for the asset classes which may be applicable to a CIV (e.g. passive market cap / benchmark UK equities) that there are other, more cost effective proven means of achieving this outcome (i.e. fee reduction). For other asset classes we have yet to see the evidence of how CIVs will deliver savings and still deliver the required governance to enable local decision making due to the differences in liabilities / asset strategy and therefore timing and type of investment requirements.

2.1.4. While Cumbria has to date had no direct involvement in CIVs, as efficiencies through collaboration are a key theme for Cumbria and due to the changing national agenda, Officers and Members have sought to gain a better understanding through communication with leading members of the "London Group"; consideration of Hymans and other consultancy evidence plus analysis from other LGPSs in this area. The conclusion we reached being that;

- Savings may be achievable for some asset classes especially for smaller LGPS's.
- The infrastructure costs of running a CIV platform that can service the wider needs of LGPS's may well prove to be more expensive than currently indicated.
- CIVs are restrictive when compared to current asset allocation and manager choice and thereby are likely to dampen performance for some Schemes.
- There could be diseconomies of scale as many of the best opportunities are strictly capacity constrained.
- There are governance issues that will limit locally discretion over both asset allocation and manager choice.
- But our greatest concern is that there has been no exploration of other means of delivering these savings, which we believe could be delivered

quicker and more efficiently by other means e.g. the use of frameworks and other means of collaboration.

2.1.5. The conflicting evidence from several external and internal LGPS experts therefore proves that this is an area where data availability and transparency needs to be improved prior to whole scale regulatory change. The creation of the "London CIV" affords the LGPS the opportunity to gather this evidence – it could be used as a pathfinder scheme not only to identify cost savings but also to share implementation experience and improve the future creation of other such structures in the future, should they prove to be desirable.

Q1b - Would CIVs deliver savings for listed and alternative investments?:

2.1.6. Our view is that CIVs may deliver fee savings (section 1.1 sets out our view on whether CIVs offer the most cost effective means of delivering savings) for some classes of investments, but that especially for alternatives i.e. usually the more risky area of investment, fees should not be the first or most important consideration.

2.1.7. Due to focus on fees and capacity CIVs may limit the number of managers funds can choose from. This may exclude some of the boutique managers many of whom have been proven to deliver favourable outperformance net of fees. This could drive a monopolistic market structure and thus see the initial fee savings disappear. This is why CIVs or frameworks would work well for markets where there is already limited competition due to required manager scale to compete effectively.

2.1.8. However, again there is conflicting professional opinion here and several matters have yet to be clarified as to how a CIV could work for alternative asset classes. This level of uncertainty means that we feel it is inappropriate at this time to use CIVs for alternative management until these governance; fees and risk matters are addressed. As such we conclude that at this time CIV's are only appropriate for UK passive management of equities where there are a limited number of managers in the market and already used by LGPS's (but as above we feel this is more efficiently managed through a framework agreement).

2.1.9. Issues of Cost comparison:-

- The report suggests that £18bn of LGPS assets currently invested in alternatives at a base fee level (i.e. not including performance fees) of 1.71%pa could be managed for 0.35% pa (including manager fees). Mercers LLC, worldwide evidence is that it would be impossible to invest even in basic infrastructure for less than 0.5% pa and this is one of the least expensive alternative asset classes to manage.

- The impact of the inclusion of performance fees skews the results & they need to be identified and excluded.
- No clarity throughout the Hymans report as to whether the fees are based on invested or committed capital, gross or net asset value.
- Additional costs e.g. operational or transactional expenses are excluded.
- Ignores the impact of taxes e.g. real estate debt investments tend to have higher management fees but are not subject to stamp duty.
- International investment managers with a proven track record of operating within the alternatives space (such as JP Morgan; Hermes; etc.) have already recognised the need for change and now offer LGPS asset sleeves. These allow for consolidation of investments to deliver fee savings from collective economies of scale across the LGPS, but have the total flexibility of local choice as to asset class; strategy type; manager and entry point. Cumbria has already opted to take the benefit of such options.

2.1.10. Fund of Funds have only been assessed on a cost basis however, there are definite risk reduction benefits from entering such structures which have not been considered. The concentration that would occur in a CIV to deliver the required savings would prohibit the achievement of most of these e.g.

- Access to global established management teams who have teams on the ground in what are complex and often geographical specific assets.
- Access to niche strategies.
- Access to top quartile (often smaller / boutique) managers.
- Access to particular vintage years which mirror the Funds liability matching requirements.
- Access to expertise in securing secondary investments.
- Enable Schemes to gain a risk-managed knowledge of new asset classes – inevitably all this learning experience will be retained at the operational CIV level.

2.1.11. Further issues that need addressing before CIVs for these asset classes are constructed include:-

- As mentioned in 1.1.4 there will be an additional layer of costs e.g. in creating the CIV wrapper; in operating the CIV.
- Currently there are no structures and staff available in the LGPS to run such a vehicle across these asset classes other than potentially for smaller scale UK infrastructure. The Pension Infrastructure Platform (PIP) has already been established for this very activity and again we believe time to review its performance should be given before wholesale regulatory change is prescribed.

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

2.2.1 Yes – we believe this to be fundamental to maintain local accountability for the running of the LGPS. Asset strategy must be a direct reflection of the liability profiles and risk appetite of employers within the scheme and this can only be achieved if decisions about strategic and tactical asset allocation are taken at a local level. Whilst taking asset allocation decisions at a national level would equalise costs to all funds / taxpayers there is a material risk in terms of tail end performance skews and volatility which would directly impact on valuations and therefore scheme deficits (all LGPS eggs would "be in one basket").

2.2.2 Because asset allocation should mirror liability profiling a detailed understanding of that liability profile and potential future trends which could inform that strategy is required. This is going to be particularly important going forward as the membership of schemes changes due to national austerity measures affecting local government and local decisions. Our view is that this is best delivered through the close working relationships already in existence between administering authorities and the employers in most county and unitary funds.

2.2.3 The exponential growth in small employers, who need support that is best offered on an individual basis at a local level (see appendix 1 for evidence of the rapid growth in employer numbers in Cumbria LGPS over the last 10 years). This is anticipated to continue as employers seek to make savings through outsourcing arrangements and where more schools progress towards academy status.

2.2.4 Again we would reiterate that when compared to the private sector LGPS investment performance is strong, (CEM initial benchmarking used by Hymans and others to support their "Call for Evidence 2013" submission) which showed that many LGPS's are getting advantageous fee structures. The focus should therefore be on supporting the Schemes where there is concern about performance not on removing flexibility which has been a core component to the achievement of the successful LGPS's.

2.2.5 Cumbria is also a more mature Scheme than most is the LGPS and thus has to carefully manage income/ cashflow and not just returns and costs. Our first objective as a pension fund is to pay our liabilities when they fall due, for a maturing Scheme this requires a detailed understanding of your membership, employer base and local budgetary constraints which will affect future profiling. This would be almost impossible to do should a move to non-local decision making be prescribed.

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

2.3.1 As per our answer to q1 we feel there are potentially more efficient ways of delivering fee savings through economies of scale than CIVs.

2.3.2 However if CIVs are developed they must be demonstrably able to achieve economies of scale and act as centres of excellence in procurement selection and management and should be structured around an efficient management and tax structure. So for London Boroughs who are usually at the smaller end of the scale, one CIV may well be sufficient. However outside London where Funds tend to be larger, the optimum number is difficult to assess and will depend on what asset classes under a CIV model. The optimum number therefore will likely be somewhere in the region of between 5 and 10, ie big enough to achieve economies of scale but not too large as to be difficult to support local involvement in their governance. But we note here there is no real experience for us to rely on in formulating this answer. Alternatively in may be appropriate to consider creating CIV's by asset class (e.g. a national CIV for each asset class).

2.3.3 In our view the asset classes more readily deliverable via a CIV would be:

- Passive equities in efficient markets (where our preference would be for a single national framework agreement rather than a CIV); and
- Direct investing in infrastructure opportunities probably at a national level where coverage and experience could be more readily brought together. Some managers are already offering the scale advantages that this would deliver, e.g. Hermes, through the creation of an LGPS investment sleeve. These LGPS specific sleeves are new creations and therefore the advantages of which have not been accounted for in the historic backward facing data collated in the Hymans report.

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

2.4.1 As per our previous points we don't believe that CIVs necessarily offer the most efficient way of achieving the desired outcomes. Again as previously highlighted we would strongly advocate allowing time for the London experience to be analysed prior to rolling out CIVs further. As this is the first large scale use of an ACS vehicle as compared to other more widely used and tested vehicle's e.g. UCITS to ensure there is sufficient evidence to assess the merits of one vehicle versus another, it would also ensure time for transfer of lessons learned. The time could also be effectively used to gather further data on the savings generated by other approaches e.g. national frameworks and LGPS investment sleeves which have only recently been developed and therefore the savings impact has not been reflected in the Hymans data.

2.4.2 Governance arrangements would be critical and must be structured to afford for local input and accountability from those designated with management of the CIV. Transparent data on performance and operational management structure of the CIV must be readily available to all participants. Funds such as Thameside; Teeside; East Riding; West Midlands and South Yorkshire have managed to develop very efficient and productive in house management teams without recourse to private sector pay structures and we feel this model of in house investment should be further developed in constructing any CIV, this means consideration as to location is essential.

2.4.3 For a newly created CIV with a potentially large number of investors, choosing which asset classes to include will be difficult. Cumbria's view is therefore that CIVs (or pools of assets) should evolve through the collaboration of a smaller number of like-minded funds who can choose to make a co-investment in individual asset classes at the relevant time and their track record will help inform other funds' subsequent decisions

2.4.4 In terms of governance we would advocate a board drawn from the funds who participate in the CIV albeit we would not want the board to become too unwieldy in terms of number of members. We would advocate some external, possibly non-executive, advisers to also be on the board. As the London CIV legal governance structure precludes active governance involvement by those Schemes outside of London we do not feel it would be an appropriate vehicle for Schemes not able to participate on this level.

Q5 In 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?

2.5.1 The Hymans report is crucially lacking in detail as to what it defines as passive management. This is a widely used generic term that often means very different things. Different types of passive management are available and before any conclusions as to the relative merits can be ascertained a definitive description of what is meant needs to be made as different definitions have a wide range of possible investment options with varying degrees of risk; performance and costs.

2.5.2 If we take the traditional form of passive management to be that of market weighted capitalisation there are a number of risks that need considering, notably that in equities the highest weighting is given to the most overvalued assets e.g. Vodafone 2000 & Financial Institutions in 2007 and in fixed income to the most indebted companies.

2.5.3 We believe there to be a place in portfolios for “passive” products however as highlighted above this needs careful consideration and it is only appropriate for certain asset classes. As detailed in our above response we believe that passive management (which we define as market weighted index products) is best delivered through framework arrangements. This would maintain the crossing opportunities from being part of a pooled fund with a diverse range of investors and likely be simpler to implement.

2.5.4 Therefore we advocate that both active and passive have a place in any portfolio but that again these decisions must be a reflection of the individual fund’s liability profile and risk appetite and required risk adjusted return net of fees and should not be a decision based purely on costs.

2.5.5 Cumbria LGPS is in the 35th quartile in the LGPS universe in terms of size of assets under management and consistently achieves 1st / 2nd quartile performance over the longer term (measured by WM). Cumbria LGPS has benefited from active management and, taking the performance over the last 5 years, can demonstrate delivery of excess return net off fees above that of passive management of £15m. If this outperformance were extrapolated across the LGPS then this would represent additional return in the region of £350m per annum. If this were coupled with reducing passive management fee structures through use of frameworks, similar savings to those put forward in the Hymans report may be achievable whilst retaining local decision-making without incurring the huge transitional, set up and management costs of CIVs.

2.5.6 We believe the split and appropriateness to each asset class should be a strategic decision to be retained locally. However we strongly believe that a passive approach, however that is defined, is not appropriate for all investment types, for example:

- Emerging market equities; and
- Corporate bonds.

2.5.6 The consultation lists four options to secure value for money for taxpayers, Scheme members and employers through effective use of passive management, while not adversely affecting investment returns:

1) Funds could be required to move all listed assets into passive management, in order to maximise the savings achieved by the Scheme.

2) Alternatively, funds could be required to invest a specified percentage of their listed assets passively; or to progressively increase their passive investments.
3) Fund authorities could be required to manage listed assets passively on a "comply or explain" basis.
4) Funds could simply be expected to consider the benefits of passively managed listed assets, in the light of the evidence set out in this paper and the Hymans Robertson report.

2.5.7 Our view is, of the options listed, the third – "comply or explain" affords the flexibility for funds to set an individual asset strategy reflective of their liability and risk profile. While also ensuring that serious consideration is given to the most optimal use of passive funds within a portfolio. This should not be used as a short term backward looking performance measure (we consider the minimum timeframe for consideration of asset performance to be 5 years) but rather as a forward looking justification for asset strategy. This would allow the funds with strong governance and track records to retain the freedom to use active management without restriction.

2.5.8 Please see Appendix 2 for further analysis of the above which was reflected in the response from the Local Government Association submitted on behalf of all Local Authorities'.

3. <u>ITEMS WE CONSIDER REQUIRE ADDITIONAL CONSIDERATION:</u>

3.1.1 ***<u>Data Transparency</u>*** - we would support the view that there is currently insufficient information available to permit a robust comparison of different Local Government Pension Scheme funds. This includes data on investment performance, investment management costs, pension administration costs, and actuarial information. All of this data should already be available within each Local Government Pension Scheme fund but there needs to be a central repository to collate and analyse the information and ensure that it is consistent and comparable. We would further urge caution on making whole scale change to the LGPS until such time as robust and comparable data is available to inform decision-making on such a critical and irreversible matter.

3.1.2 Consideration and review of data on performance needs to be reviewed in light of each fund's individual benchmarks. Cumbria has a more defensive strategy than the average LGPS fund focussing on long-term volatility rather than short term return and as such comparing performance of Cumbria against the average in a short term time horizon would, depending on the market, give misleading results.

3.1.3 Investment is not a unitised commodity but rather a bespoke strategy driven by each fund's starting position, liability profile and risk appetite. This makes comparison across funds a complex issue requiring appropriately constructed data comparison sets. This is not readily achievable through a single performance metric.

3.2.1 ***Procurement Frameworks -*** prior to the establishment of the national frameworks Cumbria achieved both savings and service improvements through collective procurement at a regional level. This can only be amplified by use of national frameworks which we will be taking advantage of in the near future as current contracts come to an end.

3.2.2 As can be seen throughout our response we are a strong advocate for further development in this area as we believe they afford the opportunity to provide for local flexibility as well as enabling the LGPS to take advantage of national economies of scale without the time lag or costs involved in other mechanisms.

3.3.1 ***Administration -*** While focus has been on investment costs due to their relative scale in the cost base of LGPS (for Cumbria LGPS they are a quarter of all costs) potential savings on administration costs should not be overlooked as these are more easily deliverable due to the regulatory, process-driven, IT dependent nature of the function which lends itself readily to efficiencies through economies of scale and effective development of IT systems which have cost prohibitive barriers of entry to smaller funds. Cumbria can clearly evidence that joint working with other funds can not only achieve readily deliverable savings but also improve data quality and service provision in this area.

4. SUMMARY AND CONCLUSION

4.1.1 We believe there may be a case for CIVs for at least some asset classes and as such further investigation is warranted. However, this consideration must be alongside investigation of other alternatives to deliver fee savings such as investment manager national framework agreements and manager created LGPS asset sleeves.

4.1.2 We believe CIV's to be most appropriate to those asset classes where economies of scale can be more readily accessed without the curtailing of investment flexibility to Schemes. For the more expensive and complex fee classes such as alternative assets further investigation is required to ensure their establishment delivers the required objective, which has got to be better risk adjusted returns net of fees, and demonstrably better governance as opposed to just lowering of fees.

4.1.3 As to the appropriate number of CIV's, while there is a case for a single CIV for London across all asset classes does have merit given the smaller fund size and indeed this argument may also apply to other geographical regions. However some London Funds may be able to make a case to only partly participate in the CIV.

4.1.4 We have no views as to what is the most appropriate legal entity if CIV's are to be implemented other than that any model created should be run on the most tax and cost efficient basis on a "not for profit fund of funds basis". It must be governed by representatives of its customers but also with some external expertise. It may well manage some buckets itself (more than likely any passive buckets) and employ external fund management organisations to manage the assets in the other buckets. But most crucially it must facilitate asset allocation strategy to remain at a local level within the individual Funds.

4.1.5 We believe that passive investment management has a place in most Schemes asset allocation strategy. It may well be an answer to "how do we reduce fund management costs?" but we believe this to be the wrong question to ask. The evidence produced by Hymans suggest that in many of the major asset classes, in aggregate, LGPS Funds pay active manager fees and get passive returns. The key words here are "in aggregate" so "on average". In some markets where LGPS Funds are major players this should not come as too much of a surprise – one would perhaps expect the "average fund" to perform not too differently to the relevant market index. What this also tells us is that 50% of funds tend to beat the index and 50% fail to beat the index. Requiring all funds to invest passively will therefore penalise those Schemes (such as ourselves) who through active management (net of fees) do achieve above benchmark returns.

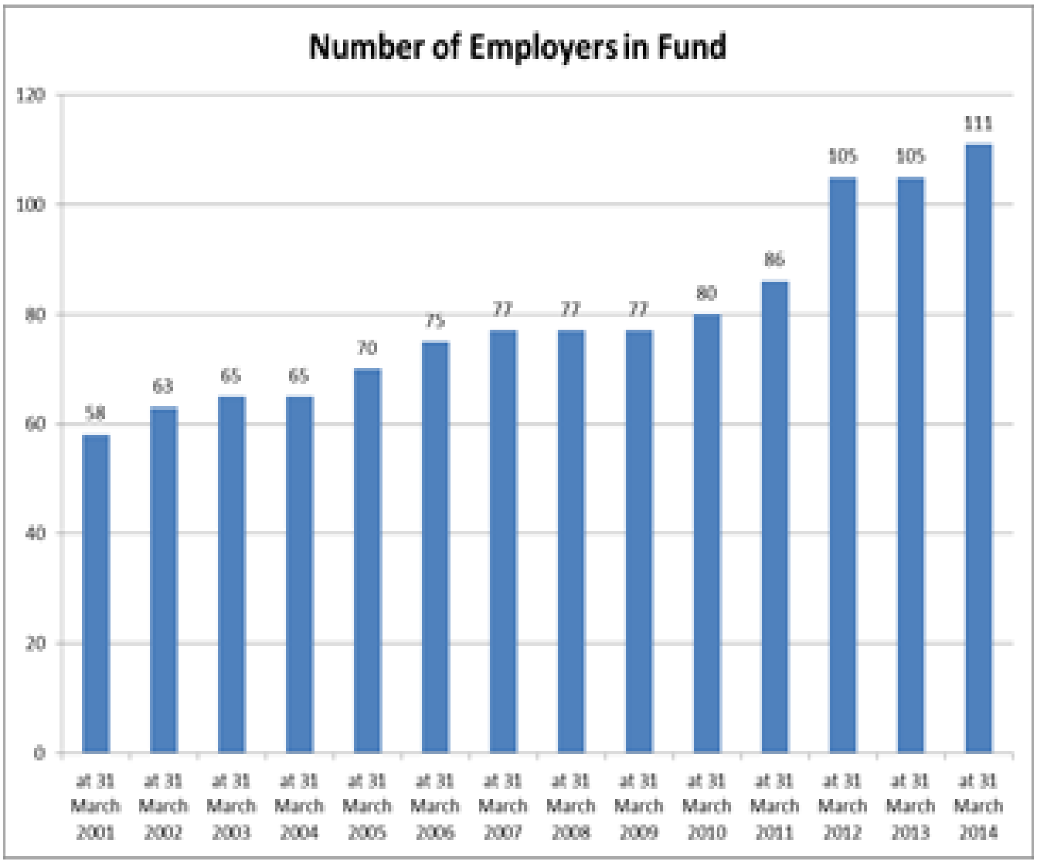
4.1.6 In our view the solution to this issue should focus more on why some funds regularly underperform and why some regularly outperform. If the practices and decisions made by those with good performance (which has consistently been proved not to be a function of size) can be adopted by those whose performance is less good, then the aggregate (net of fees) outcome could improve across the whole of the LGPS.

4.1.7 The correction question to which we should be seeking an answer is therefore; how do we help the consistently poorer performer's achieve above benchmark returns net of fees and thereby offer a real cost saving to local taxpayers, Scheme members and employers in the longer term. The focus should be on better – not cheaper.

4.1.8 We believe that there has been a positive result of this consultation and the actions that funds are currently taking. However, as stated we propose that what is required is a targeted analysis and then support to individual funds where performance is lacking. This should lead to individual improvement in the long term and which will then see aggregate performance of the LGPS will improve without the costs of lost performance to the better performing funds.. Over recent years, there are several examples of where funds have demonstrated their ability to work together (ourselves included with the joint procurement for actuarial services between Merseyside; Lancashire and ourselves (pre national framework) and the shared serve between Lancashire and ourselves for administration), the development of the London CIVs. We believe this momentum can and should be extended to investments to help deliver more cost savings and provide access to investment opportunities not currently readily available to all funds.

Melvyn Worth
Chairman Cumbria Local Government Pension Scheme

Appendix 1



Number of Employers in Fund
120
100
80
60
40
20
0
58
63
65
65
70
75
77
77
77
80
86
105
105
111
at 31 March 2001
at 31 March 2002
at 31 March 2003
at 31 March 2004
at 31 March 2005
at 31 March 2006
at 31 March 2007
at 31 March 2008
at 31 March 2009
at 31 March 2010
at 31 March 2011
at 31 March 2012
at 31 March 2013
at 31 March 2014

5. <u>PASSIVE MANAGEMENT (EVIDENCE FROM LGA SUBMISSION)</u>

5.1.1 Although the aggregate choice to move to passive across the board may seem clear as we outline above there is are considerations below the headline savings and some significant risks that must be considered.

5.1.2 ***Performance*** - Although the Hymans consultation claims no drop in performance for a wholesale shift to passive, as with all investment monitoring / performance evaluation, that is dependant of the timing both of its potential implementation and the period over which any measurement is done. For example the figures below show that although performance was on par with the index over 5 years if this policy had been implemented three years ago total LGPS return would have been 1.2% lower over that period.

Period	LGPS return 1	Index return
5 years	7.4%	7.2%
3 years	8.7%	7.5%

5.1.3 Even if the aggregate performance of LGPS funds is on or about the index there are significant patterns worth investigating beneath that overall figure. Taking WM State Street SSIA performance statistics for the 5 years ending 31.3.2013 gives the following results.

Asset class	Total LGPS return	Total Index return
UK Equities	7.3	6.7
Overseas Equities	7.7	8.6
UK bonds	8.4	7.1
Overseas Bonds	8.5	9.0

5.1.4 Over and underperformance of LGPS by number of funds

Asset class	% LGPS funds outperforming the index	% LGPS funds underperforming the index
UK Equities	78.3	21.7
Overseas Equities	55.6	44.4
UK bonds	92.3	7.7
Overseas Bonds	84.6	15.4

5.1.5 Over and underperformance of LGPS by number of weight of assets

[1] State Street Investment Analytics (SSIA) Local Authority Universe

Asset class	% LGPS asset weight outperforming the index	% LGPS asset weight underperforming the index
UK Equities	90.5	9.5
Overseas Equities	72.3	27.7
UK bonds	94.6	5.4
Overseas Bonds	73.3	26.7

5.1.6 As can be seen from the above tables the majority of funds (and assets) outperform the index in the majority of classes. Therefore we would dispute that a wholesale shift to passive across all funds and across all asset classes is a sensible approach. As detailed above we would instead advocate a 'comply or explain' approach coupled with the potential imposition of passive management targeted at those funds seen as failing.

5.1.7 ***Targeted shift to passive*** Additionally the performance / cost balance resulting from any shift to passive management would benefit from a greater degree of analysis in terms of which funds or asset class may be selected for that shift. For example if the shift to passive had been restricted to UK equities or overseas equities there would have been a significant difference in the loss or gain to the scheme as shown in the table below2

5.1.8 UK equities 2009-2013 all funds

Assets in class (2012-13)	£46bn
Total return (5 year annualised)	7.3%
Index return	6.7%
Return (using annualised performance)	£3,337m
Return (assuming all index)	£3,063m
Costs (active plus passive)	£113m
Costs (all passive)	£27m
Net impact all funds going passive for UK equities	Minus £188m

[2] Figures derived from a combination of WM State Street performance statistics, the May/June LGPS fund survey and the combined LGPS annual report 2013. Returns calculated using annualised performance 2009-2013 and spilt of assets 2013

5.1.9 OS equities 2009-2013 all funds

Assets in class (2012-13)	£59bn
Total return (5 year annualised)	7.7%
Index return	8.6%
Return (using annualised performance)	£4,518m
Return (assuming all index)	£5,046m
Costs (active plus passive)	£145m
Costs (all passive)	£35m
Net impact all funds going passive for UK equities	Plus £638m

5.1.10 However if the shift was restricted to those funds which underperformed the index in UK equities over the last 5 years the following positive effect could have resulted:-

5.1.11 UK equities 2009-2013 underperforming funds

Number of funds underperforming the index	14
Average return	5.7%
Index return	6.7%
Assets under management	£3b
Return (using annualised performance per fund)	£171m
Return (assuming at least index)	£198m
Costs (active plus passive)	£7m
Costs (all passive)	£2m
Net impact all 14 funds going passive for UK equities	Plus £32m

5.1.12 Another way of targeting the shift to passive would be to compare performance against the average in a particular asset class. For example the table below shows the impact of overseas equity return and performance if only those funds which had underperformed the average return in 4 or more of the last 5 years had been passive.

5.1.13 OS equities 2009-2013

Number of funds underperforming the index	13
Average return	6.9%
Index return	8.6%
Assets under management	£5.2b
Return (using annualised performance per fund)	£384m
Return (assuming at least index)	£452m
Costs (active plus passive)	£13m
Costs (all passive)	£3m
Net impact all 14 funds going passive for UK equities	£78m

5.1.14 ***Blips and troughs*** Following blindly to a market weighted index will mean there will be times when funds will have to face significant swings in values. As funds move towards maturity (which for Funds such as ourselves is happening at an accelerating rate) this volatility will become less acceptable, both at a Fund and individual employer level.

5.1.15 Although such swings are something funds already face, currently we seek through differencing strategic asset allocation strategies to use active management to smooth out these blips and troughs.

5.1.16 The risks presented by apparent under or over funding include pressure to take short term focused decisions and require effective management of expectations. For example individual three year valuations, which may occur at the peak or trough of the market, may not present sensible points to make radical decisions on funding and deficit recovery.

5.1.17 FTSE 100 Values

March 2001 valuation	5314
March 2004 valuation	4537
March 2007 valuation	6308
March 2010 valuation	5744
March 2013 valuation	6411

5.1.18 The above figures demonstrate that although the FTSE 100 has benefited from a significant increase in value over the total period the ride was at times rough and there was an uncomfortable degree of volatility.

5.1.19 ***Defining passive management***- Until we are clear what is meant by the term "passive management" the question over what proportion should be allocated to it as a means of investing is rather arbitrary. Passive management could and in fact is defined as anything from a predetermined strategy that does not use stock picking or timing; to matching a portfolio to an index; to picking stocks then leaving them alone for a long time or as the opposite of active. At the very least this lack of clarity will make it difficult to regulate for and thereafter to police.