UKSIF
UK Sustainable Investment and Finance Association

17th July 2014

The Rt Hon. Eric Pickles
The Secretary of State for Communities and Local Government
Eland House
Bressenden Place
London
SW1E 5DU

Dear Secretary of State

Response from the UK Sustainable Investment and Finance Association to the DCLG consultation paper: ***Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies***

Thank you for the opportunity to respond to this consultation paper. Our response draws on member feedback and discussion of the issues with interested parties.

We have some in-house fund management experience and cite that where appropriate; on other matters we have consulted with our members.

We answer the five questions posed in the consultation at the end of this response but before that we outline our views on four issues as context:

- Possible developments in pension fund investment management
- The growing importance of the government's agenda on stewardship
- Environmental, social and governance risks in investment
- The opportunity to boost the performance of laggard LGPS funds

An important theme in our response is the difference between the short-term cost of asset management and the total return after management costs of portfolios. The latter, not the former, is the key element on the asset side of the asset-liability equation which drives fund solvency and thus the need for taxpayer subsidy. We feel that the consultation's lack of recognition of this fact is a serious omission.

About UKSIF

The UK Sustainable Investment and Finance Association ("UKSIF") supports the UK finance sector as a global leader in advancing sustainable development through financial services. We promote and support responsible investment and other forms of finance that advance sustainable economic development, enhance quality of life and safeguard the environment. We also seek to ensure that individual and institutional investors can reflect their values in their investments.

We have approximately 250 members, including service providers such as fund managers, investment banks, retail banks and investment consultants, and asset owners such as pension funds and foundations.

1) Our views on the changing nature of pension fund investment and this consultation

The approach to investment practiced by UKSIF members is focused on the long-term and considers a wide variety of non-financial factors which for convenience may be called “ESG”, standing for Environmental, Social and Governance. This approach is becoming increasingly mainstream, especially amongst pension funds, and growing acceptance is shown not only by the breadth of our membership but by important regulatory and quasi-regulatory developments. For instance, the Kay Review[1] in 2011 stressed, among other important recommendations, that “stewardship” (see below) be developed further, that elements promoting short-termism such as quarterly reporting be addressed, and that “fiduciary standards” be applied throughout the value chain. We would summarise Kay’s desired state as one of informed investors operating for the long-term in the interests of beneficiaries and savers.

More recently a Law Commission report on Fiduciary Duty[2] published this month has made it clear that this concept -which is central to defined benefit pension funds- should be interpreted more widely than has been assumed by some sectors of pension fund investment. A summary of their draft guidance prepared by the Law Commission for trustees includes the following:

> *“When investing in equities over the long-term, trustees should consider, in discussion with their advisers and investment managers, how to assess risks. This includes risks to a company’s long-term sustainability.”*[3]

The law Commission’s emphasis on the long-term and on considering risk at the company level is apparent. We feel that whilst the ramifications of the Law Commission report are inevitably not yet clear, they are likely to lead to increased active management at the portfolio level since that is the best way of considering and mitigating long-term sector and company specific risks. The use of simple passive management at the asset class level cannot address these issues.

The consequences of this evolving position are of great significance for the consultation. The nature and suitability of simple, low-cost passive investment without a material stewardship element for pension funds may well now be open to challenge. Below we examine this in two further respects: stewardship and investment risk.

2) The government’s agenda on stewardship

The Financial Reporting Council comments on stewardship as below:

> *“Stewardship aims to promote the long term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship benefits companies, investors and the economy as a whole.”*[4]

And describes it further:

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[1] Kay review of UK equity markets and long-term decision making. July 2012. https://www.gov.uk/government/consultations/the-kay-review-of-uk-equity-markets-and-long-term-decision-making

[2] Fiduciary Duties of Investment Intermediaries. July 2014. http://lawcommission.justice.gov.uk/areas/fiduciary_duties.htm

[3] http://lawcommission.justice.gov.uk/docs/lc350_fiduciary_duties_guidance.pdf at paragraph 1.22

[4] https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf page 1 paragraph 1

"Activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings.[5]"

This thinking is now widely prevalent. The Kay Review asked that the concept be expanded and the Law Commission has asked the government to review whether trustees should be required to disclose the fund's policy, if any, in the fund's Statement of Investment Principles.

UKSIF firmly believes that good stewardship leads to value creation. As such, and given the financial drivers of this consultation, stewardship must be considered by asset owners and their agents. We feel that the next steps of this process should more fully consider this issue since it is lacking from the discussion on passive management.

At least one arm of government has already considered the issue; in its response to the Kay Review the Department of Business, Industry and Skills supported the view that the concept was valid and endorsed Kay's call to broaden the concept. We are disappointed that that thinking is not evidenced here.

Stewardship can be practised by active and passive managers. Kay included a direction to market participants that said:

Passive managers should recognise a special responsibility to improve the performance of the index they track.[6]

The current active management of the Local Government Pension Scheme ("LGPS") is recognised as strong on stewardship. The commitment to that practice must be as strong going forward whether through active or passive routes. It seems most unlikely that a simple, lowest-cost, approach to passive management as proposed in the consultation would reach either the current LGPS level or that envisaged by Kay.

3) Environmental, social and governance ("ESG") risks in investment

In this section we examine how clearly evidenced but difficult to price risks can be missed by conventional passive management at potentially significant cost to the LGPS and thus taxpayers. These risks might be addressed either by appropriate active management or more sophisticated passive management.

Environmental, social and governance risks ("ESG") are a group of issues which, whilst difficult to explain in financial terms, clearly have financial implications for asset owners. An example would be the oil rig explosion suffered by BP in the Gulf of Mexico. It has been argued that poor governance at senior executive and board level allowed a deficient safety culture to develop which made the accident more likely, and the disaster had clear environmental impact. Neither of these governance or environmental factors could be easily modelled the day before the explosion, but that both were financially material became clear very soon after.

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[5] https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf page 1 paragraph 4

[6] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf page 50

It is likely that these and other ESG factors will become increasingly important in determining fund total return in the future. Decisions on the future management style of the LGPS must consider them or the mechanisms chosen risk being inappropriate.

The scale of risk is material. An important instance is how future management arrangements can deal with the "carbon bubble"[7]. The carbon bubble is the recognition that if climate warming is to be kept to even 2°C hydro-carbon companies will be unable to burn more than 20% of their stated reserves. The implications of this for all hydro-carbon companies are immense, as also for other sectors such as transport and alternative energy suppliers. With hydro-carbon companies representing approximately 10% of world equity market value[8] and 6% of world bond markets[9] any loss of value linked to this issue is likely to be a central component of future total returns for the LGPS.

Conventional passive management arrangements, if introduced, would demand that the LGPS simply hold those hydro-carbon assets as they lose value. The saving on management fees compared to the value loss might well be negligible. One would hope that active management would tend to avoid these losses as the risk became apparent.

Clearly the passive management industry is not blind to these risks, and indices and funds designed to mitigate them are emerging. These can be called "sophisticated passive management" strategies. But it is sensible to assume these will cost more, and it must be recognised that in some ways these are active management strategies since some party is taking a view on how market values will move. These issues should be considered as part of the consultation.

Overall scheme governance in this area is very difficult. If a form of passive management is adopted some party will have to be responsible for, in this example, either ignoring the carbon bubble risk or for deciding which index to track and what level of hydro-carbon reduction to make. In active management those risks sit partly with professional managers, which is a far better position in terms of governance.

UKSIF views the complexity of coping with ESG risks as one of the most serious challenges facing pension schemes over the next 10-15 years and it should be properly considered in the LGPS consultation process.

4) The opportunity to boost laggards

An important area of potential improvement for the LGPS as a whole is improving the performance of the worst performing schemes. By tending to treat the LGPS as a whole the Hymans Robertson research risks missing important detail. That report does show the spread of investment returns but it does not consider that improving poor performance might be a cheaper and more rapid option than some under consideration in the paper.

We make comments on the need for good governance in our response to question 4 below, and it may be that considering the standards currently being applied in each fund in the LGPS is a sensible and immediate way of beginning to improve laggard performance.

One important area where performance could be improved may well be manager selection. An UKSIF member has carried out an analysis which shows how the performance of their recommended managers over a period of several years is several percentage points ahead of their benchmarks. This suggests that

[7] http://www.carbontracker.org/site/carbonbubble
[8] http://www.msci.com/resources/factsheets/index_fact_sheet/msci-world-index.pdf retrieved 15/07/14
[9] Personal communication from UKSIF member

manager selection can add real value and that the highest standards should be insisted upon. This is not inconsistent with the approach to stewardship and long-termism we have discussed above. Manager performance monitoring is essential; it is when it is carried out over very short time periods that it becomes a negative.

Responses to your questions

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

There is no doubt that fee rates can vary inversely with fund size, but the relationship is limited and will vary across asset classes. For every fund, the fund manager involved will probably want to cap the fund to limit business risk, and for some strategies involving small companies or specialist approaches the maximum practical size of fund may be surprisingly low.

Some CIVs in core asset classes might be liquid, scalable and cheap but the probability is that a significant proportion won't be. Driving the pressure for fund proliferation will be the desire and need of owners, particularly larger owners, to fine-tune their investment strategies. As an example a small owner may just want simple exposure to US equities as a diversification measure. A larger owner with a legitimately more sophisticated investment approach may want just medium-sized US equities. Those needs conflict and might not be easily met by a single fund or even a family of funds. A sub-optimal investment strategy will compromise financial performance; it may be hard to measure precisely in comparison to an annual management charge, but experts would agree that the fund would be bearing a "cost".

Our discussion of the issues surrounding the carbon bubble is also relevant here. It is probably inevitable that the individual financial positions of the LGPS constituent funds mean there will be a wide variety of optimum modelled responses to that multi-asset class challenge. Even if some of those can be grouped together how easily can a CIV cope with the prevalence of strategies linked to that one question?

Whilst pooled funds are the ideal solution for small investors, blanket mandated usage may well be sub-optimal for large.

The idea of CIVs in alternative asset classes may be more attractive. However, the extent of that attraction will depend on the degree to which the investment is made "bland" to meet as many fund needs as possible in terms of factors such as risk. liquidity, and correlation.

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

Yes.

A welcome feature of government policy has been the shift to devolving responsibility for financial affairs to the appropriate level. This was demonstrated recently in the proposals to reform annuity purchases. It is also implicit in the Government's response to the Kay Review which was that the existing financial services value chain be reformed rather than restructured. As such, leaving responsibility for asset allocation with local fund authorities is sensible.

We also note the explicit recommendations[10] in the Law Commission report on Fiduciary Duty that particular aspects of that subject which relate to the LGPS should be clarified so that the existing structures can operate better. The application of the recent work from Kay and the Law Commission would argue strongly that the existing system should stay in place. (These recommendations are also discussed in respect of Q4.)

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?

We are not experts in CIVs and cannot comment on the best number of CIVs or other structures.

But based on member feedback and on our knowledge, and as mentioned in the answer to Q1 above, we think that optimum investment returns at the fund level would only be generated by offering access to a wide range of vehicles so that funds can tailor their investment strategy.

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

As mentioned above we are not experts in the detail of CIVs and instead we will focus on governance.

It is now probably generally accepted that the governance of a scheme is the most important foundation for success. A properly governed scheme will have mechanisms in place to recognise and manage both risk and opportunity in all aspects of its work: investment, administration and reputation. A good scheme will review its personnel and their capabilities; it will consider how to manage its advisers and how to get the best from them; it will look forward rather than backwards.

Central to this is having the right people and processes. It is noteworthy that both Kay and the Law Commission envisage structures where individuals acting in accordance with their recommendations operate as just that: individuals doing their best. Implicit in those pieces of work is that capable people in the right environment are the best governance mechanism.

In our view good governance of any new vehicles would demand the existence of a body comprised of just such independent, non-conflicted individuals. That body might not be the executive arm but it should have "clout". In particular it may have the very difficult role of resolving the inevitable conflicts between the differing needs of the various LGPS bodies invested in the funds. Any new vehicles must be run for the benefit of all unit-holders in a vehicle, not just the largest.

It seems to us that several comments from the Law Commission are relevant to this question, notably:

- That the government review applying the "invest in the best interests of members" criteria from the IORP Directive to the LGPS
- That the government review the regulation which requires review of fund managers at least every three months
- The recommendation that in the defined contribution area "independent governance committees embedded within pension providers owe a statutory duty to scheme members to act with reasonable care and skill, in members' interests"[11]

[10] Law Commission report paragraph 12.4
[11] Law Commission report, paragraphs 12.4 and 12.5

The first two of these comments seem to show a view from an authoritative source that the governance bar in respect of LGPS needs to be shifted up. That movement is not to be in terms of the frequency or regularity of action since the second topic goes against that box-ticking approach; instead the movement is to be in terms of quality and is exemplified by the introduction of the best interests criteria.

The third comment is not directed at the LGPS itself but at the evolving area of defined contribution pension governance. In that area, and with a relatively clean sheet of paper, the Law Commission has recommended a high standard of governance. It would seem therefore perverse for the governance regime of any new LGPS vehicles to be set lower than this.

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?

We have not performed a comprehensive analysis of the Hymans Robertson work but we have heard sceptical comments from a significant number of UKSIF members. We are also aware that the Investment Management Association has cited evidence and made arguments relating to the actual level of fees paid by LGPS and the achievable reduction in transaction costs and we would support their evaluation based on our experience of fund management.

One comment we would make is that to assume that active management is a zero-sum game for funds the size of the LGPS is debateable. Large funds diversify to avoid concentration of risk; to say that the concentration of LGPS funds in any one global market is so large as to generate the zero-sum risk suggests not that it should just be accepted with passive vehicles but that more diversification is needed. In fact we are sceptical as to whether the zero-sum risk does exist on a persisting basis in any market for LGPS but that is an opinion and nothing more.

We would recommend that some of the apparent outcomes of the Hymans Robertson work be retested.

In our discussion and answers above we have raised concerns about how well simple passive management of the kind proposed can cope with issues of stewardship, governance and emerging investment risks such as those in the "carbon bubble". Sophisticated passive management may cope better but has not been considered at length in the consultation. For those reasons the first three options as presented are not appropriate in our view. We would instead urge a version of the fourth option: namely that if funds are not already considering passive management as part of their ongoing processes they be asked to do so. That recommendation would be entirely consistent with best practice for trustees in reviewing their investment arrangements and with our comments on governance.

I trust that our comments and answers are self-explanatory but if we can help in anyway please contact us.

Simon Howard
Chief Executive
UKSIF