CLWYD PENSION FUND

CONSULTATION RESPONSE

OPPORTUNITIES FOR COLLABORATION, COST SAVINGS AND EFFICIENCIES

Introduction

This is a response on behalf of the Clwyd Pension Fund   The consultation questions have been considered by the Advisory Panel for the Fund and agreed with the Chair and Vice Chair of the Clwyd Pension Fund Committee. The Advisory Panel includes senior Flintshire County Council officers with delegations for managing the Clwyd Pension Fund, an investment consultant (JLT Investment Consulting), actuary (Mercer Limited) and independent adviser (Aon Hewitt). In framing our response, we have reviewed evidence produced by our advisors (and others).

Flintshire County Council administers the Clwyd Pension Fund on a lead authority basis. The Clwyd Fund is one of the eight funds in Wales. The Fund is currently valued at £1.2bn with 35,000 members. All our listed assets are already held in pooled vehicles, we do not hold segregated assets.

We have responded to each of your questions and added some additional comments and alternative approaches for consideration as the Government takes this consultation forward.

In summary we would like to express the following beliefs:

- CIVs have the potential to achieve benefits of scale and good governance which was the conclusion of the earlier study undertaken by the eight Welsh Treasurers.

- There is scope to increase the use of passive management but active management still has a role.

- 'Comply or explain' is the best option for both the use of CIVs and passive management

- Good governance is the key at local level and around the CIVs

However it is the size of deficits that poses the significant challenge:

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- There is no magical solution. However investments are governed it will not solve the problem or reduce employer costs in the short term.

- Tackling accessible cost savings is worthwhile but will only chip away at the deficits.

- Therefore the approach and compulsion to use CIVs and passive management should be commensurate with the impact.

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

In general terms we agree with the Government's conclusion, which itself recognised the research of 8 Welsh Pension Fund's that also concluded, with evidence, that CIVs were a way forward.

However, we do not believe that there should be compulsion to participate and funds should be able to hold assets outside a CIV (s) on a 'comply or explain' basis.

Applying a similar approach to the national frameworks being developed and used for other pension fund services, CIVs should be developed 'by the LGPS for the LGPS'.

In our opinion the benefits of CIVs are:

- Reduction in time and cost of appointing and monitoring fund managers and reduction in transaction costs.
- Focus Committee time on strategy rather than implementation.
- Some reduction of fees through economies of scale.
- Provide access to alternative fund managers and strategies which individual funds may find difficult although Funds should not be prohibited from accessing individual alternative fund managers.

Additional Comment

The Clwyd Fund has experience of investing in alternative asset classes and would like to draw attention to the dispersion of returns within each of these asset classes. These risks will need to be fully understood by all those participating in the 'Alternative CIV'. We would urge the Government, if not already done so, to engage with specialist groups across these asset classes, such as the British Venture Capital Association (BVCA), to fully understand the risks involved before determining the governance arrangements around such a CIV.

Q2

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

Yes.
A fund's asset allocation should be decided locally, after taking proper advice, to deliver their funding plan and reflect their appetite for investment risk.

Q3

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

We do not feel able to give advice on the number of CIVs. There is a potential solution, as a Welsh Fund, that a Welsh CIV (s) could be created but in terms of size it may be dwarfed by larger English CIVs, especially the alternative CIV. It is the governance around the CIV that is key, rather than size.

Our preferred approach would be to create CIVs by asset class rather than have multi-asset CIVs.

In terms of asset classes, we list below those we believe are the most important to be established. We think the range should cover those main market areas and be run on a passive basis. Hopefully economies of scale would lead to a small reduction of fees across the LGPS based on current asset allocations. This would not make the level of savings outlined in the consultation but should marginally reduce the amount of governance required. In addition, based on the evidence in the consultation, it is possible that Funds will decide locally to increase their passive allocation and this would make procurement more efficient and lower implementation costs

Listed (NB All passive):

UK Equity
US Equity
European Equity (EX UK)
Japanese Equity

UK Government Bond
UK Government Index Linked

However, evidence we have seen from our investment consultant (and also our own Fund experience) also highlights that there are asset types where a passive fund management approach detracts from return even after allowing for manager fees and transaction costs. Although,we do not feel that CIVs should be established, initially on an active management basis, as there is such a wide potential variation in performance and risk characteristics, over time this could become an attractive option for some smaller Funds which have limited Governance budgets to select and monitor active managers.

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Alternative Assets

The range of fund types in this area is extensive and therefore makes the establishment of even a limited range of CIVs for this area complex. As a result it may be difficult to achieve savings or reach agreement across Funds. Shown below are the areas we feel that need to be covered.

Private Equity (by region and global) and/or
Private Equity (Venture, Mid Market, large MBO)

Property (by region) and/or
Property (Core, added value, opportunistic)

Separate Hedge Fund Strategies (long/short equity, event driven, global macro, managed futures, convertible arbitrage, equity market neutral, credit long/short and distressed)

Currency funds (with various risk/return tolerance for both developed and emerging currencies)

Commodities (various benchmark exposures, plus timber and agriculture)

Infrastructure (higher risk return/green field projects to lower risk/return income generation and inflation protection)

Additional Comment

A manager could be appointed or a platform developed (or purchased from a consultant) which could manage assets on a tactical basis in a separate CIV (or a sub fund).

As required by the 'Myners Principles' each fund is required to have a policy on responsible investment. The Government should factor the need for such local flexibility when considering any compulsion to participate in CIVs.

Q4

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

In Wales, the next stage of the process would have been the appointment of a consultant to undertake a full business case to advise on the structure of the CIV and the governance arrangements. This has been put on hold until the outcome of this consultation is known. Hence, we cannot advise further on a structure or governance arrangements apart from recognising how difficult this may be especially for an alternative asset CIV where risk of poor performance is much higher.

Additional Comment

As stated in Q3 above our preference would be CIVs by asset class. Each asset class could have its own fiduciary manager and the implementation of each CIV could be directly via the manager or the fiduciary manager may provide a platform of other managers (manager of manager approach). We urge the Government to undertake further research in this area to determine the cost and benefits of such an approach compared with the proposed multi asset CIV. We believe performance of these vehicles would be easier to monitor and the governance structure simplified. The National Advisory Board (via specialist sub groups of LGPS practitioners and consultants) would be responsible for hiring and firing the fiduciary managers. This could be implemented on an incremental basis, asset class by asset class as LGPS funds become comfortable with the approach and see the benefits of participating in the CIVs. This approach could be especially effective for alternative assets.

Critical to the success of any actively managed CIV will be the choice of manager(s). This requires great care, and considerable work will need to be done in respect of who is chosen.

Q5

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

In our view 'Fund authorities could be required to manage certain types of listed assets passively on a 'comply or explain basis'. The logic behind this choice is explained below.

Additional Comment

The Clwyd Fund undertakes its own research every four years. The last fundamental fund structure review was 2010 and another review is planned for later this year. The Fund came to conclusions after interviewing about 10 global fund managers and consultants. We also have an investment performance record for total assets, various markets, LGPS average and our fund manager returns from 1993/94 to 2009/10.

The process involves general research on markets and products, a review of our Fund which involves using an optimisation model to determine the strategic asset allocation (risk, return and cost), and then implementation of the revised strategy.

Returning specifically to your question, a conclusion we made following research and statistical analysis in 2010 was that developed equity markets are efficient and therefore post-fee out-performance against benchmark is more difficult to achieve on a consistent long term basis.

As a result we terminated 5 regional active equity manager mandates (19% of the total Fund) and replaced with one passive manager through a competitive process (NB if a collective investment vehicle had been available it could have been used voluntarily. It would have saved time and cost and possibly at a lower fee). The fund managers terminated had not all underperformed but we took a long term view based on our research. Reduction of fees is simply an outcome of the decision.

Hence as far as developed market equities are concerned we concur with Hyman's research. It should be noted though that we have one unconstrained global equity manager (for 5% of the total fund) who has outperformed the MSCI AC World by 4.3% p.a. as at 31st March 2014 over a 3 year period, net of all manager fees and transaction costs.

However our research suggested that alpha can still be achieved by fund managers in less efficient markets, Asia Pacific, Emerging (and more recently Frontier) equity markets. This seems to be backed up by our fund manager performance in these markets. As at 31st March 2014 both have outperformed their benchmark, one by 2.2% p.a. and another by 3.1% p.a. both over three years (again these returns are net of all manager fees and transaction costs).

From our point of view we have received excellent value for money for the active fees paid and our decision to continue with active managers for these markets has been vindicated. However we recognise that these markets will continue to mature and the decision will be re-considered at our next review.

In terms of fixed income markets we have one manager for corporate bonds, high yield, emerging market debt and loans who manages these on both a tactical and active basis. Credit crisis apart this approach seems to be working and paying for fees and although this approach will be reviewed we would be reluctant to change based on evidence we have since 2007. Detailed evidence is the property of one manager hence we are reluctant to provide any further details here.

We are also following a flight-path methodology for our funding strategy. This involves investing in gilts (or similar) to de-risk and 'match liabilities' as our funding level or markets reach certain triggers. The benchmark is the Clwyd Fund specific liabilities, as calculated by our actuary, but this is then managed on a passive basis and hence passive fees are paid to the fund manager.

The most important part of our Review is the determination of our investment strategy. Here we do make assumptions of the long term beta returns we expect from markets and measure risk through information ratios. We are attempting to find the most efficient portfolio. At this point we consider whether market beta is sufficient or whether the fund needs to pay additional fees for alpha to achieve the returns required to meet the funding plan.

The purpose of the above comment is to outline that we do already consider these matters locally in some detail and believe this discretion should continue to be delegated by the Government to local funds. However, local funds should also be able to demonstrate the reason for using active management and paying active fees for listed assets. Hence we believe 'comply or explain' will provide best value for money for stakeholders.

We would also like to bring the following to the Government's attention:

- Funds have multi asset, growth or tactical funds which will invest in listed assets on an active basis. Our view is that these should be excluded from any decision made on passive management
- Markets and products change over time as we have found during each of our four yearly reviews. Any solution should recognise this and will need to be constantly reviewed.
- Passive management can also be provided on a synthetic basis, which is the Clwyd Fund's current approach for regional developed equity, or using ETFs is another option abeit not as tax efficient over time compared to holding stock. Given these various options the Government will need to consider the exact definition of passive management and how it is provided.