Cyngor Sir y Fflint
Flintshire County Council

AUDIT COMMITTEE

Date of Meeting	Wednesday, 21 November 2018
Report Subject	Clwyd Pension Fund Governance
Report Author	Clwyd Pension Fund Manager

EXECUTIVE SUMMARY

During a review of the Clwyd Pension Fund Statement of Accounts 2017/18 by the Committee, the monitoring of fund management fees and value for money was briefly discussed. It was agreed that the Committee would receive a report and presentation to give further assurance on this matter.

An outline of the Clwyd Pension Fund (the Fund) governance arrangements is provided along with further background information on fund management fees, an explanation of why the Fund currently pays these fees and concludes on how value for money is measured and where it has been achieved.

The Council's Constitution delegates the management of the Fund to the Clwyd Pension Fund Committee. The Committee is advised by officers and professional advisors.

Every three years as part of the Actuarial Valuation process, which determines employer costs, the investment consultant recommends to Committee an investment strategy which targets the required investment return but as importantly also manages investment risk. The fund management fees are a result of how these risks are managed and the investment strategy is implemented.

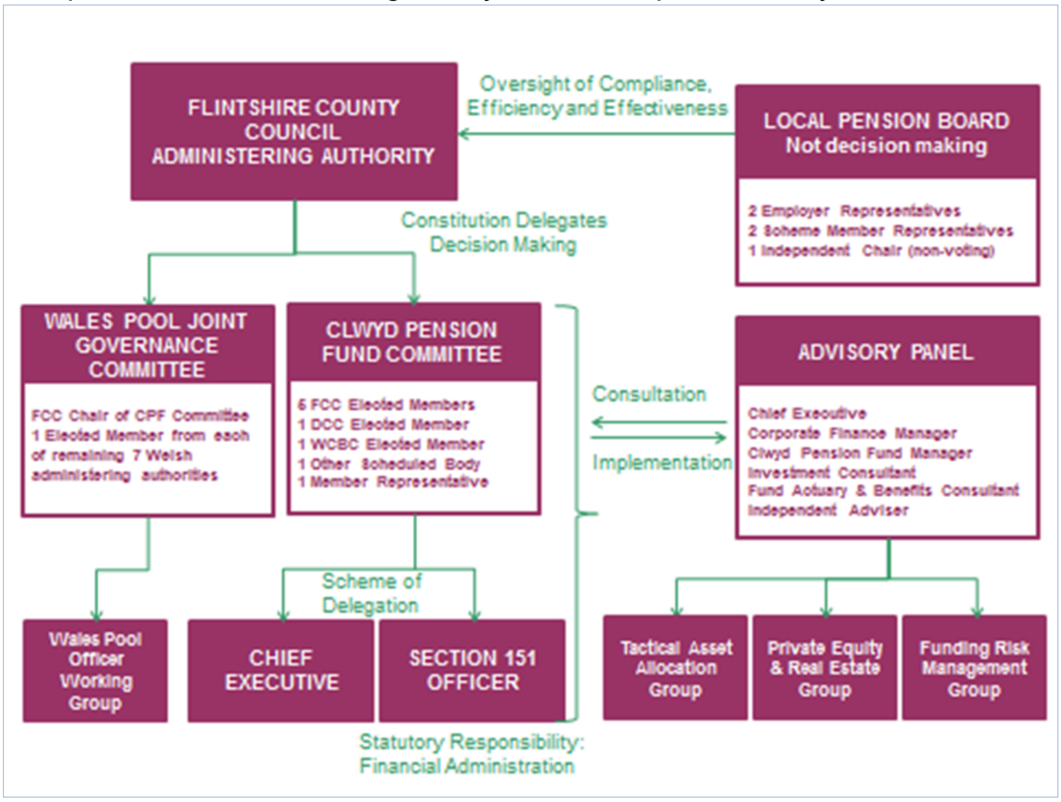
The report demonstrates that at a total fund level the investment strategy has achieved its objectives and that fund manager fees have provided value for money.

RECOMMENDATIONS	
1	That the Committee consider the report and provide feedback to the Clwyd Pension Fund Committee.

REPORT DETAILS

1.00	GOVERNANCE

1.01 The diagram below illustrates the governance structure for the Clwyd Pension Fund. It is described fully in the Governance Strategy and Compliance Statement a regulatory document published by all LGPS funds.



1.02 LGPS Regulations allow for some local discretion on governance arrangements. Both the compliance statement and an annual independent report demonstrate that the Council complies with best practice and the Fund is well governed. Unlike the Committee, the Pension Board is a statutory requirement whose role is to provide oversight of compliance, efficiency and effectiveness but is not decision making. The most recent addition is the Joint Governance Committee for the Wales Pension Partnership (WPP) which will provide the platform for pooling investments across the 8 LGPS funds in Wales. In the future fund management fees will come via this pool.

1.03 The Council's Constitution documents the delegations to the Pension Fund Committee, the Board Protocol and WPP. The Fund has other published governance related documents but those particularly relevant here are:

- Funding Strategy Statement.
- Investment Strategy Statement
- Risk Policy Statement
- Training Policy Statement
- 3 Year Business Plan
- Annual Report & Accounts

	The Clwyd Pension Fund Committee receives a quarterly report on investment performance of the Fund and fund managers.
2.00	**FUND MANAGEMENT FEES**
2.01	Fund management fees are usually expressed as basis points (bps) against the value of the assets managed, where 1.00% = 100 bps. Hence if market value increases so do the fees in absolute terms and vice versa. Generally, the more invested the lower the bps charged which is the theory behind why pooling investments should result in lower fees. Fees vary by asset class and within asset classes.
2.02	**Investment styles** **i) Passive or Active** It is possible to achieve a return which maps the market return (beta) for an asset class, and this is known as **passive** investing and can be done at a relatively low cost. The more value you ask a fund manager to provide above the market return (known as **active** investing or adding alpha) the higher the fee as you are paying for the skill of that fund manager. For example, using listed equity as an asset class, to achieve a market return could cost say 1-4bps, but ask a manager to beat the market by 2% per annum could cost say 30 – 50 bps. There is much debate and research on which approach provides better value for money. Fees for investing in equity also vary across geographies, for example fees will be higher for investing in the less liquid, less transparent Emerging Markets but the returns are expected to be higher over the longer term.
2.03	**ii) Private Equity** Private equity investing can add significant value, as the manager will actively buy, hopefully increase its value over a number of years and then sell a private company. This style of investing requires the investor to lock in the capital for a number of years, and is therefore only suitable for investors that can manage this illiquidity. The manager will be very proactive in managing the investments and as such fees are much higher at around 100 – 250 bps but so are the potential returns; on average +6% above listed equity markets might be expected over the long term.
2.04	**iii) Volatility/Protection** However, especially in listed equities if the market falls by 20%, the passive investor value falls by 20% but the active investor is still likely to fall by 18 – 22%. Therefore pension funds do not just pay fees for potential higher returns; they can also pay fees for protection against severe and continuous falls in equity markets or to give less volatility of return. For example hedge funds can play a role within a diversified portfolio because they are often designed to increase in value when traditional markets fall. The cost of this protection can be relatively high with fees often in the region of 200bps but value for money can best be measured at times of severe stress in the market. Another way of protecting the Fund against adverse movements in the value of assets compared to its liabilities is to create a portfolio that moves in a

	similar way to the liabilities. This is known as Liability Hedging, or Liability Driven Investing (LDI).
2.05	**iv) Diversification** In reality a pension fund will have a mixture of these and other assets and styles of management in its overall strategy dependant on funding position, maturity and trustee attitude towards risk. There is no right or wrong answer because each pension fund will be in a different situation but the asset allocation will be the driver for the level of fees. The fund will aim to have a diversified portfolio that will help it to achieve its strategic requirements whilst managing volatility. Whether these fees provide value for money is then dependent mainly upon the market and will vary over market cycles.
3.00	**CLWYD FUND PERSPECTIVE**
3.01	Every three years the Fund Actuary undertakes an actuarial valuation to determine both the cost the employers needs to pay for the future benefits of members and any deficit payments for past service. Within the resulting Funding Strategy Statement the actuary will assume an investment return for future service contributions and deficit payment. At the 2016 Valuation the investment return assumption for future service was CPI +2.75% and past service was CPI +2%. In simple terms, if these target returns are not achieved by the return on the Fund's assets the cost falls back on employers at the next Actuarial Valuation.
3.02	The investment consultant considers how best to achieve these returns on a consistent basis and designs an asset allocation which considers both return and risk. The current strategic asset allocation is shown below:

Asset Class	Strategic Allocation (%)
Developed Global Equity	8.0
Emerging Market Equity	6.0
Credit	15.0
In-house Assets	22.0
Real Assets	*12.0*
Private Markets	*10.0*
Tactical Portfolio	21.0
Diversified Growth	*10.0*
Best Ideas	*11.0*
Managed Account	9.0
Liability Hedging	19.0

3.03	At the time of design this allocation was expected to achieve CPI +4.1% (on a best estimate basis) with a 10 year time horizon. It was also calculated that in terms of stress testing a 1 in 20 year downside event could add approximately £245m to the funding deficit.
3.04	The Fund's focus is very much on downside market risk and the impact of inflation on the value of liabilities and minimising the impact on the cost to employers in these scenarios. However, given the LGPS is still an open scheme we still need to generate enough return i.e. take investment risk, to meet future liabilities. It is this balance that is difficult to achieve and this risk management that can result in higher management fees.
3.05	The Fund's Investment Strategy Statement explains how the Fund attempts to achieve this balance and shows the expected risk and return for each asset class which is part of the diversified asset allocation. An analysis of this is shown at Appendix 1.
3.06	**Fund Management Fees**

The fund management fees paid by the Fund for each asset class is shown below:

Asset Class	Fees	
	£000's	bps
Equity	2,114	80
Credit	172	8
In-house: Real Assets and Private Markets	10,399	269
Tactical Portfolio	1,163	33
Managed Account	962	64
Liability Hedging	951	24
Total	**15,761**	**90**

The table shows fees by asset class for the last full financial year (ended 31 March 2018) and should be viewed in conjunction with the Strategic Asset Allocation, and the risk/return expectations shown within the Appendix.

3.07	**Investment returns**

The overall Clwyd Pension Fund achieved 3 year annualised returns to the end of September 2018 of 11.8% net of fees compared with the strategic target of 6.3% and the actuarial target of 4.2%.

	The table below shows return by asset class and the target return in the market conditions:

Asset Class	12 months %		3 years % p.a.	
	Fund	Target	Fund	Target
Equity	7.0	10.6	18.1	21.3
Credit	-0.6	1.5	2.8	1.4
In-house: Real Assets and Private Markets	7.4	6.7	10.9	5.7
Tactical Portfolio	2.9	5.5	7.4	5.3
Managed Account	0.3	4.0	-0.7	4.0
Liability Hedging	14.8	14.8	23.4	23.4
Total	**7.7**	**7.6**	**11.8**	**10.3**

The table shows:

- Most of the asset classes have achieved their target returns over a 3 year period.
- There has been very strong growth in listed equities over the 3 year period but the equity fund managers have not achieved their targets over these periods.
- Overall fees paid have provided value for money.

4.00	**CONCLUSIONS**
4.01	In terms of fees, most of the fees in percentage terms are charged in real assets and private markets and the managed account as expected. The real assets and private markets portfolios have achieved a very good return but in this market have not outperformed listed equities. Real assets and private markets include: private equity, infrastructure, property, timber and agriculture.
4.02	The returns on the managed account are disappointing but this allocation is in place to protect the Fund during falling markets, which have not been the case during this period. If we have had a 'crystal ball' we could have invested more in equity at a very low cost during this three year period. Unfortunately it is impossible to predict markets. Global Equity markets could have fallen significantly this period or this could happen in the future.
4.03	The Fund's 3 year Business Plan includes an investment strategy review during 2019/20. The Fund is in a very different financial position than the last Actuarial Valuation (at the time of writing) so it is expected that the asset allocation will change which in turn will change fees. The investment consultant will be instructed to implement at the lowest possible cost without sacrificing the risk management and downside protection already imbedded. Going forward fund manager appointments and fees will be the responsibility of the WPP. An external organisation CEMs Benchmarking has been appointed to benchmark these costs.

4.04	In summary, the Audit Committee should be assured that on balance value for money is being achieved from the fund management fees. Investment returns have exceeded targets net of fees. However, given recent positive markets a higher return could have been achieved at a lower cost as taking more equity risk would have been rewarded, but this is impossible to predict. The Fund's risk management approach is designed to reduce the impact on employers during sustained periods of falling markets and higher inflation Achieving this at the lowest possible cost will be considered again during the investment review next year.

5.00	**RESOURCE IMPLICATIONS**
5.01	None, but this report considers value for money of the £15m of fund management fees reported in the 2017/18 annual accounts.

6.00	**CONSULTATIONS REQUIRED / CARRIED OUT**
6.01	None directly as a result of this report.

7.00	**RISK MANAGEMENT**
7.01	The report discusses pension fund and employer financial risks.

8.00	**APPENDICES**
8.01	Extract from Clwyd Pension Fund Investment Strategy Statement – Risk/return assumptions 2016/17

9.00	**LIST OF ACCESSIBLE BACKGROUND DOCUMENTS**
9.01	Clwyd Pension Fund: Funding Strategy Statement; Investment Strategy Statement; Training Policy; Risk Policy; Business Plan; Clwyd Pension Fund Committee Papers; **Contact Officer:** Philip Latham, Clwyd Pension Fund Manager **Telephone:** 01352 702264 **E-mail:** philip.latham@flintshire.gov.uk

10.00	**GLOSSARY OF TERMS**
10.01	(a) **CPF – Clwyd Pension Fund** – The Pension Fund managed by Flintshire County Council for local authority employees in the region and employees of other employers with links to local government in the region

	(b) **Administering authority or scheme manager** – Flintshire County Council is the administering authority and scheme manager for the Clwyd Pension Fund, which means it is responsible for the management and stewardship of the Fund. (c) **PFC – Clwyd Pension Fund Committee** - the Flintshire County Council committee responsible for the majority of decisions relating to the management of the Clwyd Pension Fund (d) **LPB or PB – Local Pension Board or Pension Board** – each LGPS Fund has an LPB. Their purpose is to assist the administering authority in ensuring compliance with the scheme regulations, TPR requirements and efficient and effective governance and administration of the Fund. (e) **LGPS – Local Government Pension Scheme** – the national scheme, of which the Clwyd Pension Fund is part. (f) Investments terms – A glossary of investment terms produced by the Investment Association can be found here: https://www.theinvestmentassociation.org/all-about-investment/glossary.html?letter=A#term-9