HYMANS ROBERTSON

# Conference highlights

**LGC Investment Seminar Scotland (The Principal, Edinburgh)**
**To pool or not to pool: that is the question**

The LGC's annual investment seminar Scotland was held on 23 and 24 October. The key themes from the conference were: structural reform in Scotland, a focus on generating predictable returns and the impact of technological change and responsible investment. A summary of the sessions is set out below.

## Chair's welcome

The Chair (William Marshall, Hymans Robertson) opened the seminar on a positive note by saying that, even taking into account recent market volatility, Scottish LGPS funding levels may have improved by around 5% since the 2017 valuations. As a lead into the first session, William outlined the four options currently under consultation in the Scottish LGPS structure review.

## Discussion session on the SLGPS consultation on the structure review

**Richard McIndoe, Strathclyde**

- The fund's view is that the "status quo" has generally worked well. Strathclyde and other Scottish funds have strong funding positions. Getting value rather than just reducing cost should be the objective. Strathclyde don't always invest cheaply and being too large can be an issue. There is scope for more collaboration – funds should really work together to deliver outcomes, rather than just share information.
- Pooling compromise reached in E&W,is expensive and takes up lots of resource. However E&W needed to take action quickly. Fund merger is a big risk and reduces diversification. Upside probability may improve but impact is big if things go wrong. In summary, funds face big challenges, but these are not generally due to structural reasons.

**Bruce Miller, Lothian**

- Status quo is not an option. Pooling can bring economies of scale, but messy governance and not Lothian's preference. Greater collaboration is the 'not so easy' easy option. It can have benefits as noted from Falkirk & Lothian joint working.
- Mergers are preferred by Lothian as the 'elegant' option and should achieve better governance, internal resourcing and cost savings. The long term rewards are worth the short term disruption.
- A single £47bn fund could deliver savings of £65m pa out of current £225m pa based on Lothian's own model of internal and external management.
- Attendees then discussed the 4 options via breakout sessions. Results of "Slido" polls – the majority of attendees voted for the 'more collaboration' option prior to the breakout sessions. This was still the case afterwards, although the gap between the 'more collaboration' and 'merger' options had narrowed.

## Investment strategy – how to ensure it is fit-for-purpose and future proofed

**Sorca Kelly-Scholte, JP Morgan**

- LGPS needs to be growth orientated, to pay future benefits and deliver returns required by the valuation. However, long term returns expected are reducing and developed economies are ageing.
- The current economic cycle is mature. There has been a long period of expansion, but still above trend growth, so a collapse may not yet be imminent. The length of this 'late cycle' could be many years so stay in, bank returns and think about resilience factors such as diversification.

**Ted Logan, Blackrock**

- Cash returns are higher than inflation for the first time in years. Logan is seeing clients increasingly looking at 'secure income assets' such as infrastructure debt or equity (e.g. wind farms), real estate (eg social housing), or private credit.
- He did flag that there are challenges to be overcome with such real assets, including levels of illiquidity premium, transparency (reputational risks), high/complex fees, and hidden portfolio risks.

## Responsible investment (Richard Keery, Strathclyde)

- It was agreed that there is a big challenge to manage climate change and divestment on fossil fuels, with pressure from activists such as Bill McKibben.
- Richard stated it is better to be an 'active owner'– vote globally, engage via partnerships, do shareholder litigation and impact investing.
- It was noted that divestment may not have a major impact on a stock's subsequent performance as ownership will be quickly bought up, by potentially less responsible investors.
- Climate change due to lots of reasons e.g. methane, factory farming, livestock, cement and deforestation, and fossil fuel use is systemic in our society.

## How long term institutional funding can regenerate town centres (Peter Manners-Smith, M&G)

- Works in partnership with local authorities e.g. better staff accommodation, regeneration projects, town centre projects, new schools to create a vehicle for investors.
- Different examples were discussed e.g. Conwy County BC civic building, Rochdale BC shopping and leisure centres, office buildings in Middlesborough.
- Investment features are income strips, long leases, inflation linked, regular cash flow backed by real estate, and attractive illiquidity premium above gilts and bonds.
- Typical minimum investment size is £15m.

## Hot topics from around the LGPS (Richard Warden, Hymans Robertson)

- Two national initiatives were discussed. The cost management process may lead to benefit and/or employee contribution rate improvements in April 2020 (if Scotland similar to E&W experience). The section 13 report on Scottish funds is due next year.
- Other topics were exit credits (which allow employers to access surplus for the first time), flatter life expectancy trends, the move towards 4 yearly LGPS valuations, the 'separation project' in E&W, hikes to employer contributions in unfunded schemes and TPR concerns over LGPS data quality.

## The infrastructure and housing challenge

**Dan Batterton, L&G**

- Dan stated that build to rent offers better returns than property, lower volatility, needs-based demand (leading to full occupancy), short term leases, and high correlation to inflation (rather than wealth growth & GDP).

- Investor benefits were flagged as being quicker build than 'build to sell', improvements to rental standards in existing stock, and inflation linked cash flows. He highlighted that it was important that properties were designed for genuine community living. Features include 6 month to 5 year leases, no agency fees, CPI linkage, 2 month break clause, 24/7 on site staff, free wifi, and being pet friendly. If investing overseas, speak to local advisers to understand local cultures.

**Andrew Liau, Ardian**

- Discussed a case study involving Luton airport. Its key achievements were a new brand identity, a more "exciting" terminal, better customer experience, and major transport improvements for the airport.
- Retail contracts were structured to guarantee rent regardless of sales volumes.
- Andrew stated this was a good example of public-private partnership. Airport job numbers increased by 25% (plus other local jobs), leading to more tax for the local council. Non-contractual bonuses were paid to employees.

## Technology Disruption: the changing landscape (Alan Custis & Jenny Hardy, Lazard)

- It was flagged that the time from concept to full adoption is accelerating e.g. fridge took about 40 years, but internet only 10 years.
- The internet was agreed as a game changer. Most notably increases price transparency – lots of new companies have taken advantage but older businesses are embracing too and capitalising on new technologies. AI and machine learning is also on the rise.
- Surviving disruption? Examples were discussed of firms that are on the front foot –Tesco, BP and ITV.

## The merits of low volatility equities (Stewart Piotrowicz, Lothian)

- Historic evidence suggests that low volatility equities consistently outperform higher risk ones over long time periods. It was noted that value destruction can arise on equities as values don't move in straight lines e.g. a 50% fall requires a 100% rise to restore the value. 'Efficient compounding', achieved by holding equities with a lower market beta, can give the best outcomes and reduce the risk of value destruction.

## Lessons learned from pooling in England and Wales (Jeff Houston, LGA)

- Pooling timeline - 5 years and counting! There has been lots of consultation and roundtables, with Government targeting a £600m saving. The 4 pooling objectives are scale (£25bn), robust governance, savings whilst maintaining performance, and infrastructure investment. The new Minister is meeting funds soon to discuss infrastructure and updated CLG guidance is due in late 2018.
- FCA authorisation process has been a challenge. It's a unique situation as pools are managers who work only for their owners i.e. the ceding funds. Most debates between funds vs pools is around control of asset allocation decisions. Different pools taking different approaches. Often boils down to choice vs efficiency.