HYMANS ROBERTSON

Sixty second summary

Structural Efficiency and the LGPS

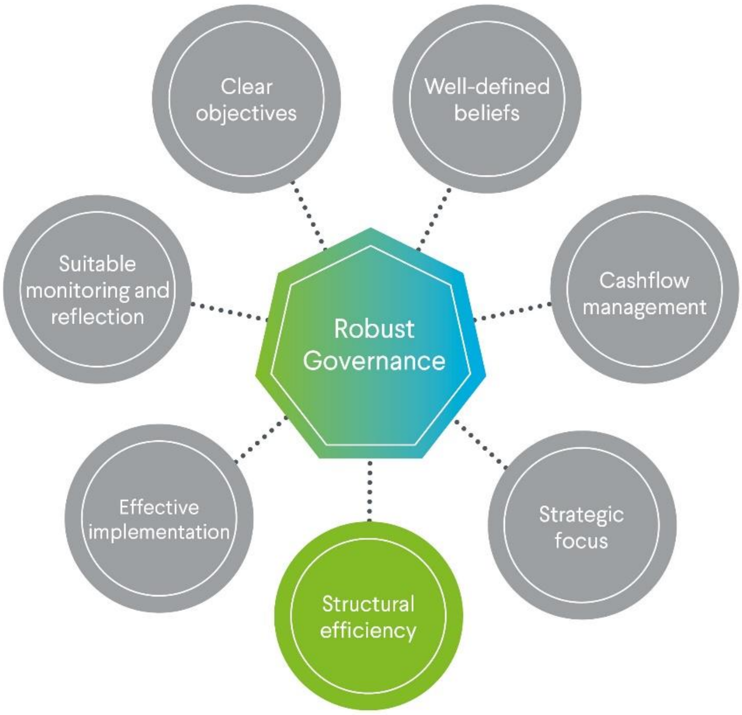
Key messages

- A well-diversified equity structure is key to achieving a Fund's beliefs and objectives.
- While equities are expected to deliver superior long-term returns, these returns are volatile, and therefore it's important to diversify by region and investment style.
- Committees who wish to explore investment in sustainable equity strategies should be clear on how the strategy aligns with their beliefs and investment objectives and if this can be part of an integrated approach to responsible investment.

A closer review of your investment priorities

With the valuation year for the LGPS in England and Wales now in its latter stages, it's important that Committees continue to consider how their investment arrangements can best achieve their objectives. We've set out a framework for robust governance (see diagram below) which highlights key areas to focus on, as a visual to guide you towards achieving and maintaining success.

In previous 60 Second Summaries, we first identified clear investment objectives and well-defined beliefs as core elements of the framework and the key point of departure from which to assess investment risk and to plan your investment arrangements. We've since discussed strategic focus and cash flow management as further areas of importance for long- and short-term sustainability. This emphasises the need to balance the level of contributions with the investment risk needed to generate required returns, and the importance of understanding your cash flow profile and ongoing obligations in its context.



In this 60 Second Summary we highlight **structural efficiency,** as it fits within the robust governance framework. Given LGPS Funds tend to have large or majority allocation in equities, we discuss the strategic role equities play in achieving Scheme objectives and some factors to contemplate when designing your Fund's equity portfolio.

The remaining key elements of **effective implementation** and **suitable monitoring and reflection** will be explored in a future 60 Second Summary.

Equity structure

A Fund's equities are expected to deliver higher long-term returns than other asset classes, although this comes with elevated risk in terms of the volatility of those returns. It's important to structure your Fund's equity arrangements to ensure you get the most out of this asset class and achieve the best solution when designing a portfolio to meet your beliefs and realise your objectives. Key considerations for pension funds for structuring equity allocations efficiently are:

- Ability to deliver long-term enhanced returns (relative to other asset classes);
- Diversified and complementary styles;
- Diversification by region; and
- An integrated approach to responsible investment.

We believe that diversifying by region or by investment style enables Funds to reduce risk and at the same time access a broader range of returns, for example investing across both developed markets with strong financial systems and developing markets with expectations of higher economic growth rates. Similarly, through complementary styles with a mix of underlying factor exposures, Funds can generate positive excess returns and address the challenge of timing different market factors. It's important your equity strategy provides exposure to a range of styles such that no individual style dominates.

Key questions to address:

- As the pooling and transition of assets continues, have you considered the implications of LGPS Pooling on your equity investment arrangements? How might your equity strategy evolve in response? Are you able to create savings and efficiencies in other ways?
- Can I improve the structural balance of the Fund's equity strategy through regional and style exposures?

Sustainable equities

We highlight above the importance of applying an integrated approach to responsible investment. In recent years sustainability has been a major focus in equity investing and the development of ESG products is still one of the fastest growing areas in the market.

Sustainable equity is still evolving, but generally entails investing in companies with sustainable earnings growth, companies affiliated with themes of sustainability, or companies directly aligned with the UN's Sustainable Development Goals, to list a few approaches. Amongst sustainable funds we see those that directly integrate ESG considerations into stock selection, and 'impact funds' which aim to drive measurable social or environmental change through their investments. Moreover, our high-level research has shown that historical returns of a sample of sustainable strategies were like that of a sample of active equity strategies. While this is not guaranteed, the finding does lend credence to the hypothesis that the sustainable strategy, of itself, need not lead to lower returns.

A proliferation of sustainable indices and funds, increased diversity in the criteria for their construction, and the availability of comparative analysis sources for these products, means that a variety of approaches are more accessible to Committees than ever, with a growing ability to make informed choices on the available strategies.

Key questions to address:

- How active do you want to be in sustainable investing? Would you like to make this a core part of your equity strategy or a complementary addition?
- How does your Fund want to implement an integrated approach to responsible investment and how can your equity allocation be structured efficiently to achieve this?

Summary

Structural efficiency is an important element of investment governance. As the 2019 valuation year unwinds, Committees should contemplate how well their equity structure reflects the objectives which they have set out for their Funds. Please speak to your Hymans Robertson consultant for further information.

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London | Birmingham | Glasgow | Edinburgh T 020 7082 6000 | www.hymans.co.uk | www.clubvita.co.uk