HYMANS ROBERTSON

LGPS 2017

Survey of independent advisers

Introduction

Welcome to our 2017 survey of independent advisers working with Funds within the LGPS.

Our survey considers responses from 19 independent advisers to some of the largest LGPS Funds in the UK. In total, our respondents help advise over half the LGPS (in terms of assets under management). Their answers covered the key issues of scheme objectives, risks and investment beliefs together with the topical themes of LGPS Pooling and Environmental, Social and Governance (ESG) issues.

In the remainder of this report we provide detail on the responses we received, including some of the quotes that were provided. We believe our survey results give an interesting insight into the thinking of key influencers within the LGPS, most notably the points outlined below.

Objectives: 90% of respondents felt that Committees have a clear understanding of their Fund's current investment objectives. However, only two thirds were of the view that Committees had a firm view of how their investment strategy will look once the Fund's objectives have been achieved.

Investment beliefs: Unanimous agreement among the independent advisers that statements of investment beliefs are important and are a key part of Committee's decision making frameworks.

Investment risks: Economic risks, most notably of not being able to generate sufficient asset returns, was identified as being the biggest investment risk that Fund's face (85% of respondents agreed).

Employer investment strategies: Around 50% of those surveyed were of the view that individual employer strategies are likely to form an important part of the LGPS's future.

Managing cashflow: Only 60% said that their Fund's net cashflow positions are discussed regularly at Committee meetings.

Environmental, Social and Governance: The majority of respondents agreed that ESG is highly relevant when Funds are choosing and monitoring providers. However, some expressed a degree of scepticism, highlighting that, in their opinion, ESG matters take a disproportionately large amount of time, relative to other Fund considerations.

Asset Pooling: Around 85% of responses were concerned about the costs of setting up and transitioning to asset Pools. Nevertheless, almost 80% believe that pooling can result in Funds benefiting from greater economies of scale. There was also consensus that Committees having a greater focus on strategic decisions, may well be beneficial.

Future role of investment consultants: Around 80% of respondents see the role of investment consultants as helping Committees develop their approach to risk management.

We discuss these findings in more detail in the remainder of this report.

We thank all those that responded to this survey and are delighted to hear any comments or questions that readers of this report have in relation to the findings of this analysis.

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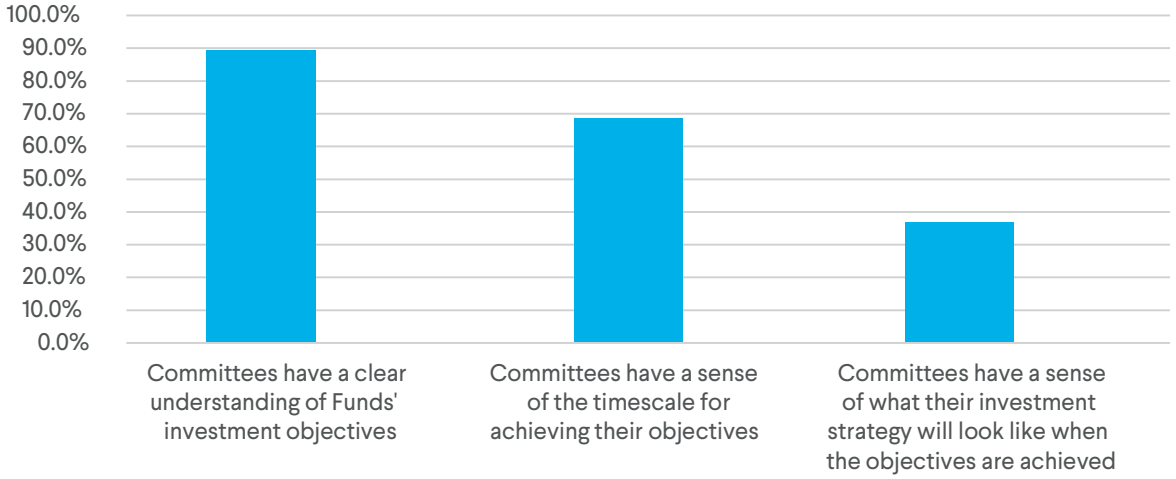
Question 1

Objectives. Please highlight which statements reflect your view.



We asked the independent advisers whether, in their view, Committees have a clear understanding of the following points:

- Their Fund's investment objectives;
- A sense of the timescale for achieving their objectives;
- A sense of what their investment strategy will look like when the objectives are achieved.

Comment

90% felt that Committees have a clear understanding of their Fund's current investment objectives. However, only two thirds thought that Committees had a firm view of how their investment strategy will look once the Fund's objectives have been achieved.

> *"Most Committees understand that they have a finite period to achieve full funding, which is usually some way in the future, and most understand broadly why they are invested and what they are invested in. I don't think many have thought ahead to the point when they reach full funding and what their portfolio will look like"*
>
> (William Bourne – Linchpin IFM)

The responses are broadly consistent with our own experience. In summary, there is generally a greater understanding of where things are now, and why a Fund's investments are structured as they are, with the details of how the investments may evolve over time being less clear at this time.

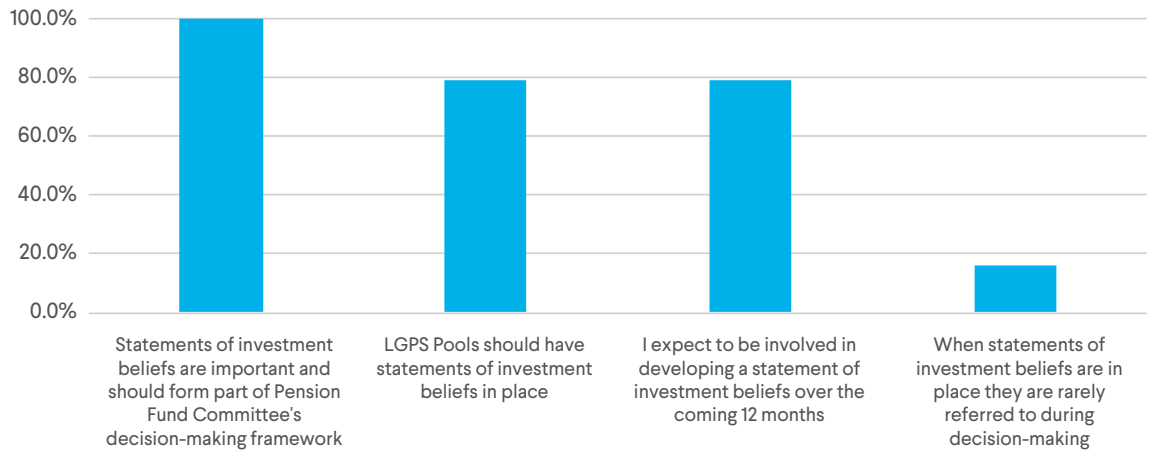
We believe that clear objectives are essential to the successful management of an LGPS fund. Knowing where your Fund is going, and how you intend to get there, are key elements of your Fund's journey. In our work with clients, we are addressing several key questions:

- **What does "full funding" mean?** The long term objective for a Fund could be to achieve a balance of investment risk and contribution rate that is different from the current funding strategy potentially implying a lower discount rate and lower level of investment risk.
- **What actions should be taken on the journey towards full funding?** It is unlikely that an LGPS Committee would wait until their funding targets had been reached before taking some action on investment strategy. We expect that a gradual move towards a lower level of investment risk will be common place. We have seen some clients consider a "funding fulcrum" long term position, balancing contributions at an "affordable" level, together with the Fund assets being able to generate sufficient return to meet the ongoing cost of benefits.

As we see funding levels improve and Fund's become increasingly diverse from a maturity and liability profile perspective, we believe, there is an increasing need for Committees to consider what long-term balance between funding and investment risk that they would be willing to accept so plans can be put in place to work towards this.

Question 2

Investment beliefs. Please highlight which statements reflect your view.



Comment

Interestingly, there was unanimous agreement among independent advisers that statements of investment beliefs are important and are a key part of Committee's decision making frameworks.

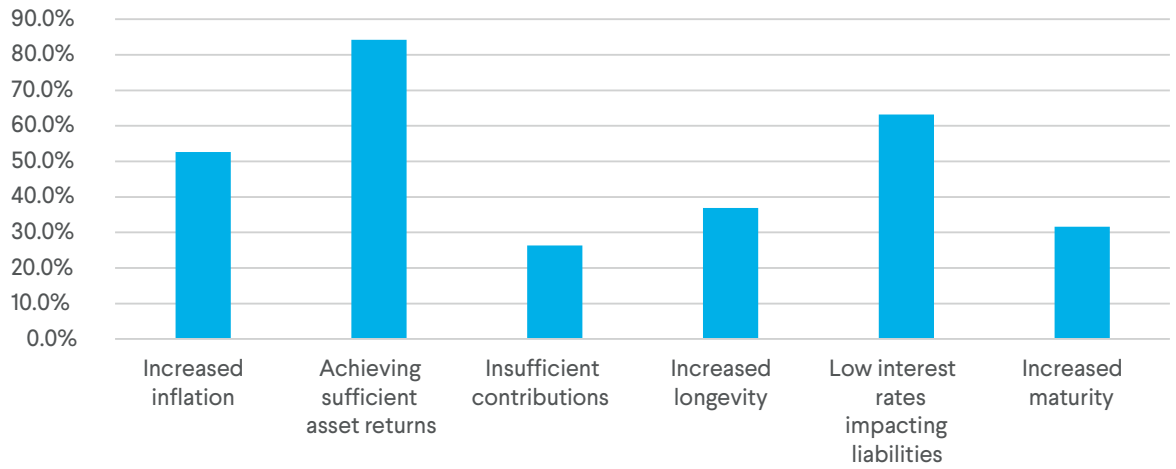
We believe a clearly articulated set of investment beliefs is hugely important in helping a Pensions Committee consider its decisions in light of those beliefs. With increasing external scrutiny of Committee decisions. Having clearly defined Fund objectives, married with a well defined set of investment beliefs, will help Committees to explain their decisions in a clear and concise way. For any Funds without a set of investment beliefs, we strongly recommend that you consider putting them in place.

For those that already have investment beliefs, we encourage you to:

- revisit them to ensure they are appropriate;
- test your investment strategy relative to them to ensure the beliefs are being reflected; and
- confirm how they sit relative to your Pool's offering.

Question 3

Risks - What do you view as being the 3 main funding and investment risks that will impact Funds' ability to achieve their objectives?



Comment

Interestingly, it is the economic risks of insufficient asset returns, low interest rates and the potential for increased inflation that independent advisers are most concerned about. It is also noteworthy that insufficient contributions was the element that the advisers were least concerned about, something which was a surprise to us, given the current pressure on public sector spending and that any lack of investment returns are, most likely, going to need to be paid from contributions.

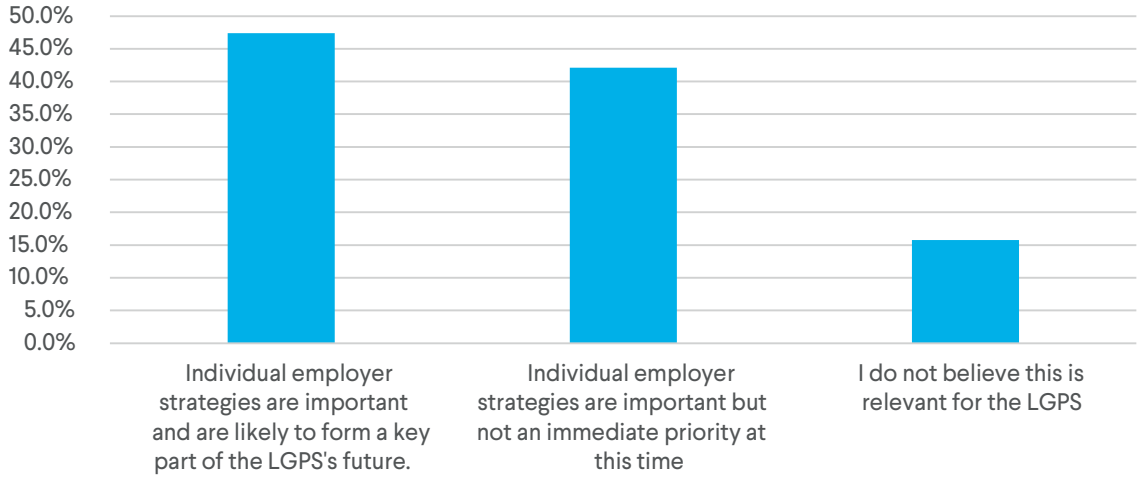
The risk of Fund's being unable to generate sufficient asset returns is a concern that we share and which we have commented on previously, most notably at the recent LGC Celtic Manor conference.

LGPS funds have the ability to take a long term view, and generally have sufficient scale to access a very wide range of investment opportunities (this ability to take advantage of scale is likely to be strengthened with the move towards pooling). Increasingly, as Funds mature, particularly for some employers within Funds, avoiding being a forced seller of assets at inopportune times is critical. As such, an increased focus on income generating assets to reduce volatility of returns and meet cash flow requirements is becoming a key part of Funds' planning.

It is an interesting debate as to whether Funds should seek protection from the risks of falling or persistently lower interest rates and increased inflation impacting upon the value of benefit payments. Using Hymans Robertson's GrIP philosophy (Growth, Income and Protection) we believe that for most Funds, the focus will continue to be on generating the required level of long term real returns. However, for some employers, there maybe a good rationale for implementing more explicit hedges, like those more commonly seen with private sector pension funds.

Question 4

Individual employer investment strategies: Which comment most closely reflects your views?



Comment

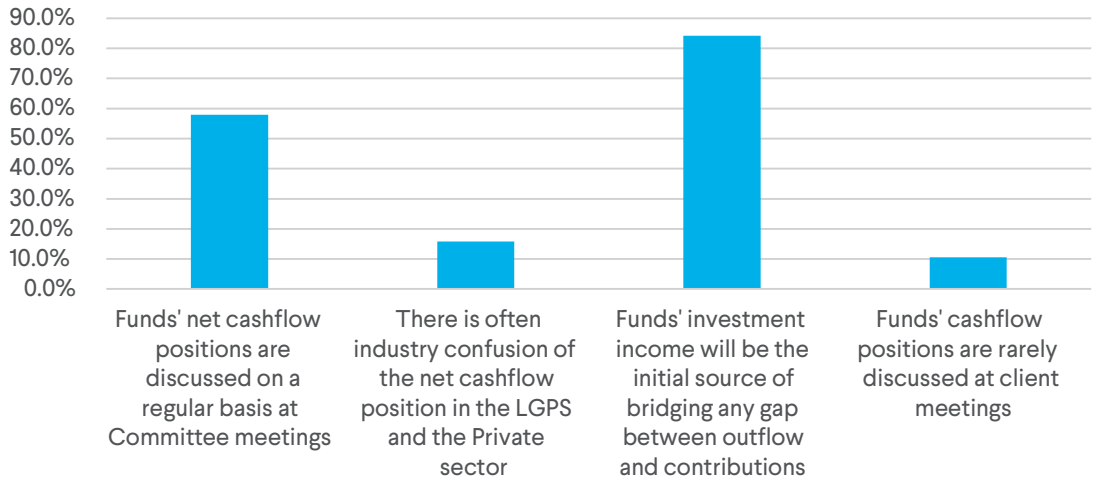
Just under half of those surveyed were of the view that individual employer strategies are important for the LGPS, with a slightly lower proportion considering them to be an immediate priority.

We have seen the greatest use of individual employer strategies where an employer has a particularly unique liability profile (e.g. a very mature employer) or is extremely well funded (e.g. closed employer heading towards cessation) and therefore, a growth oriented investment strategy is not appropriate.

We believe that the increased focus on the risk to employers from their LGPS pension obligations means that the demand for individual employer strategies will continue to grow. We also believe that the ever increasing focus on governance will mean that the Funds themselves are more concerned about specific employer risks and will be more willing to offer those employers bespoke (lower risk) investment strategies. To be able to do this, it will be important that Pools offer Funds the necessary investment offerings to help implement the appropriate investment strategies.

Question 5

Which of these statements reflect your views on Funds' net cashflow positions?



Comment

There was a consensus that investment income will be the first source of Funds used to meet any shortfall between contribution income and benefit outflow. This is something that we support.

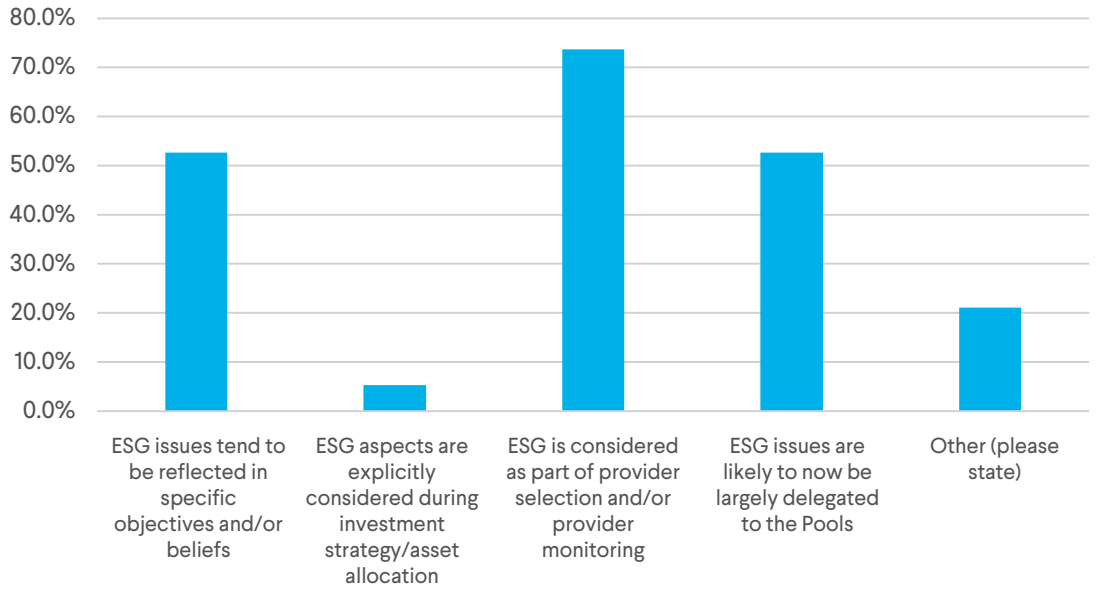
However, only 60% of the advisers responded that their Fund's net cash flow position was regularly discussed at Committee meetings. We were slightly surprised at this, expecting the figure to be higher, albeit we appreciate much of the cashflow management may take place outside of the normal meeting cycle.

Being able to meet cashflows efficiently, without being a forced seller of assets, is becoming a real issue for increasingly mature private sector schemes. For the LGPS, although maturity is a factor, cashflow negativity (on the whole) is currently nowhere near the same issue, even before you take into account investment income from assets.

Nevertheless, it is important that Funds have an understanding of their cashflow position, and the approaches that will be used to meet cashflow requirements. We believe that it is also important that Funds consider the long term strategic implications of their evolving cash flow needs (most notably the potential implications of switching to a more income focused investment strategy on the Fund's future expected returns and sensitivity to shorter term volatility).

Question 6

Which of these statements reflect your views on Environmental, Social and Governance (ESG) issues for Funds and Pools?



Comment

Our question on ESG issues drew a wide range of responses. Nearly three quarters of respondents considered ESG to be a relevant consideration for Funds in choosing and monitoring providers. However, only one of the independents responded saying that ESG issues are explicitly considered when investment strategy and asset allocation decisions are being made.

Our question on the growing importance of ESG issues in investment decision making drew a mixed response. Around half of those surveyed believe that ESG issues will be increasingly important in the future whereas others expressed a degree of scepticism with one respondent commenting that "ESG matters take a disproportionately large amount of time relative to other Fund considerations". Whilst other comments were more supportive.

There is growing evidence that firms which demonstrate positive ESG characteristics can deliver superior long term performance. In our view, ESG issues will have increasing relevance for Committees and their advisers, both as the ability of asset owners to positively influence societal outcomes grows, and external scrutiny increases.

We expect that integration of ESG issues across the entirety of the investment decision process will continue, with ESG issues being increasingly reflected in investment beliefs, policy documents, asset allocation and monitoring activity. Ensuring Pools and their underlying Funds have a consistent approach to ESG is likely to be one of the key challenges over the coming years. This was supported by a number of the comments we received in the responses (examples below).

"Good investments tend to have good ESG characteristics. The Pools will have to make ESG an integral part of their investment process as it is for many LGPS Funds already. I would expect the engaged LGPS Pool members to continue to monitor and expect good ESG while accepting that the investment decision is delegated to the Pool."

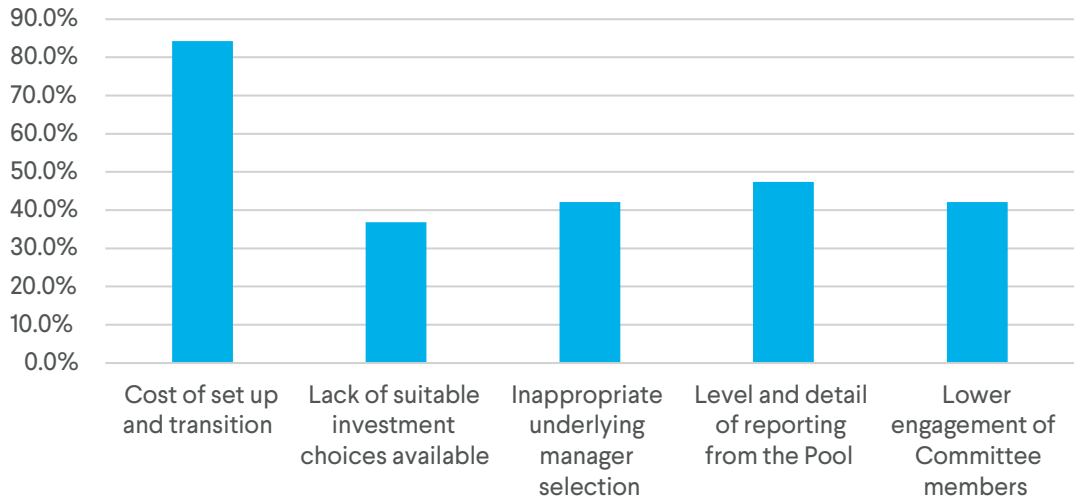
(Anthony Fletcher – Senior Advisor, Allenbridge)

"The commitment to ESG will remain largely with Funds, in some cases simply because of lobby groups and ethical beliefs, but the implementation will largely devolve to the Pools. The nature of collective investment vehicles will present a significant challenge to that last point; for example, a single authority will not be able to unilaterally impose an exclusion within a Pooled fund."

(William Bourne – Linchpin IFM)

Question 7

Asset pooling – What do you see as being the three main potential issues?



Comment

Perhaps unsurprisingly, this question elicited more comment from the independent advisers than any of the others. The majority of respondents (85%) were concerned about the costs of setting up and transitioning to asset Pools. Their concerns were largely in relation to loss of control, manager selection, reporting, and potentially lower levels of engagement from Committee members.

"The question is will Pools be better, or no better (or even worse) than Funds at selecting and (even more importantly) deselecting managers. I fear it will be no better and could easily be worse!"

(Eric Lambert – ELC Consultancy)

"I fear the focus will be solely on costs rather than net returns"

(Iain Beattie – Investment Advisor)

On the whole, there was a general sense of scepticism about the merits of pooling and the challenges involved; however, there is some recognition of the potential advantages (discussed in question 8).

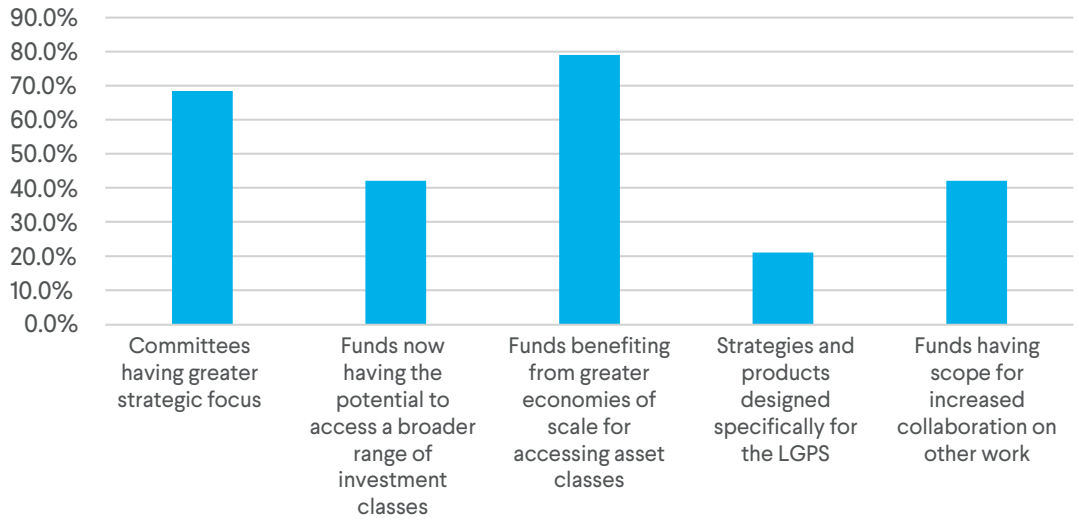
Set up are undoubtedly one of the major pooling risks although, a proportion of these may have been offset by some of the manager fee savings which have already been achieved in advance of many Pools being fully formed.

With Funds typically still to transition all (or most of) their asset into the Pools, we agree the transition process is another significant risk (a poor transition has the potential to wipe out several years' worth of manager fee savings). The soon to be launched, National Transition framework, will help simplify the process of appointing the relevant providers in this sector.

The responses reiterated that the relationship between the Pool (effectively acting as an external supplier) and the Funds needs to be carefully managed, with the former needing to offer clear reporting on all the decisions that it makes on Funds' behalf (i.e. not just manager performance). The latter needing to understand how their strategic goals and beliefs are being implemented by the Pool, challenging the Pool where it is necessary to do so.

Question 8

Asset Pooling – What are the potential advantages?



Comment

Despite scepticism (see question 7), it is interesting that almost 80% of the independent advisers believe that pooling can result in Funds benefiting from greater economies of scale. There was also a consensus that Committees having a greater focus on strategic decisions may well be beneficial. Having this additional time is likely to tie in well with the comments on the need to have greater clarity on what the investment arrangements should be at full funding and the potential need to develop specific strategies for certain employers.

The responses suggest some scepticism that asset pooling will result in investment products specifically for the LGPS being created, or that pooling will increase the appetite for Funds to collaborate on other matters. We are slightly surprised at this. We believe there is considerable scope to design solutions, most notably in the alternatives area, that more accurately reflect the needs of the LGPS e.g. to help generate long term real returns at affordable costs. We have already seen some positive steps in this area and expect there to be more over the coming years, albeit they are likely to take time to develop. There is also evidence of Funds working more closely together on non-pooling matters e.g. training, and think that there is appetite for this to increase across like-minded Funds.

"(Pooling) is a substantial exercise and the Pools, as significant fund managers, will have to operate from the off at a higher level than those from existing funds are used to. If not, they will not inspire the necessary confidence and will come under significant pressure from their clients.

Much depends on the quality of appointments but, in the early stages of pooling, the Pools should seek help from investment advisers and investment consultants who have knowledge in key areas such as the investment choice, manager selection, and client reporting."

(Leslie Robb - Investment advisor, ex-partner Baillie Gifford and Co)

Question 9

Investment consultants - how do you think that they can help Funds in the new environment?

Comment

The majority (nearly 80%) of independent advisers see the role of investment consultants as helping Committees develop their approach to risk management. This is precisely the role that we see investment consultants providing to the LGPS. We believe that considering investment, funding and employer covenant risk together is essential in helping Funds develop an integrated approach to risk management. To do this successfully, Committees and their advisers need to tap into the full range of tools available to them in running their pension scheme. This includes making use of the investment opportunities presented by asset pooling, as well as making increasing use of technology, to facilitate easy measurement and monitoring of Funds' progress relative to objectives.

We are slightly surprised by the low response to helping facilitate the relationship between the Funds and the Pools. On private sector schemes, we see clients with fiduciary arrangements use consultants as independent assessors of the decisions made by the fiduciary manager. We see the potential of similar arrangements having merit in the new world of pooling as Pools will be making a number of decisions on how Funds' assets are being invested (the specifics of which will vary from Pool to Pool).

"The individual funds are going to continue to need to take professional advice from some source in order to fulfil a more complex asset allocation function. Instead of approving an allocation across bonds, equities, property, and perhaps alternatives against their liabilities, they will have to approve an allocation across anything from 7 to 30 subfunds. For example, how will they allocate between gilts and corporate bonds, if those are two separate subfunds? The average Pension Committee does not have the skillset or the timeframe flexibility to do that. The question is where they will choose to take that advice from, and whether they will be willing to pay for it."

(William Bourne – Linchpin IFM)

Question 10

What are your thoughts on LGPS Funds' approach to training?

This final section focused on approaches to training in the LGPS, and helping identify potential areas where further training is required.

The responses were supportive of Committees having ongoing training plans in place, ideally aligned to the projects that the Funds are facing at that time. Specific areas that were highlighted for further training are included below:

"the need to understand the investment models that are used to assist in decision making"

(Eric Lambert – ELC Consultancy)

"to take a more granular look at ESG matters e.g. good governance, long term sustainability, and potential impact investment"

(Karen Shackleton – Senior Adviser Allenbridge)

"I believe that some Committee members could benefit from a better understanding of bond markets and how interest rates / yields and discount rates impact the expected returns on investments"

(Anthony Fletcher – Senior Adviser Allenbridge)

We strongly support training being a core requirement of Committee members. Training is something that should sit alongside the Funds' annual business and governance plans. In addition the LGPS's current focus on MiFIDII, and the potential of LGPS opting up to professional status, reiterates the regulatory need for ongoing learning and development plans to be in place for members.

There are a number of tools that are available to help identify members' training needs and for building training arrangements around (most notably CIPFA's Knowledge Skills Framework). We support Funds developing an approach that works best for them, typically either holding specific training days (at least annually) or looking to include training as a standing item on meeting agendas with the training item tying in with work relating to the Fund.

The need for training will very much remain in the new world of pooling, with Committees responsible for the returns from their Funds' assets, even though a number of investment decisions' may be delegated to the Pool.

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