

UNCOVERING THE INVESTMENT PERFORMANCE DRIVERS OF LOCAL GOVERNMENT PENSION SCHEMES (“LGPS”)

The Hidden Cost of Poor Advice: LGPS Review - Part 2

“There is surprisingly little assessment or measurement of the impact and effectiveness of investment consulting advice, either on asset allocation or manager selection.” - Lord Myners, 2001¹

Introduction:

In this report CLERUS presents a two-factor model which identifies the key drivers of investment performance between LGPS. As we have already revealed², the majority of Schemes have poor investment specific governance vis-à-vis performance measurement. This report therefore identifies the other key drivers of investment performance using available LGPS data.

The analysis reveals that more than 60% of the performance variation between Schemes can be explained by two factors:

1. The performance of manager selection relative to the Scheme specific benchmark
2. The percentage allocation to assets classified as “alternative”

For the majority of Schemes, investment decisions have become little more than the implementation of the recommendations made by their investment advisors. However neither the recommendations nor their impact are being measured or assessed by most Schemes (>90%). This lack of performance measurement probably explains how the £17.3 billion cost to the tax payer has been allowed to accumulate over the last 5 years.

It is CLERUS’s belief that this type of analysis can assist the current Government consultation on reform in the LGPS sector. By focusing on investment outcomes rather than potential ‘cost-savings’ alone, we are able to provide a practical proposal for the current consultation. We have used the LGPS analysis to evaluate the potential future performance impact of current Government proposals.

Which factors explain the differences in LGPS Performance?

One reporting relic from the past that has not gone away is the reporting by Schemes on their percentile performance within the WM Local Authority Universe. 57% of Schemes still do this, either exclusively or often with more rigour than other metrics. However this comparison has two main flaws: first, as we illustrated in our initial report, it is a very poor benchmark for overall investment performance, governance and investment decision-making; and secondly, this relative performance comparison does not take into account differences in the strategic asset allocation between schemes.

Table 1: Possible explanatory variable for performance – values as at 31st March 2013

Structural Features	Tactical Implementation*	Asset Allocation Characteristic
<ul style="list-style-type: none"> • Scheme size • Percentage of assets managed in-house 	<ul style="list-style-type: none"> • Manager selection = Performance relative to benchmark net of fees • Number of external managers • Percentage of assets managed passively 	<ul style="list-style-type: none"> • Investment management Fees • Allocation to equities • Allocation to fixed income • Allocation to property • Allocation to alternatives

*Tactical implementation consists of the choice of management style (active/passive) and the selection of managers to implement the chosen benchmark style against the chosen benchmark

¹ Institutional Investment in the UK: A Review. March 2001

² The Hidden Cost of Poor Advice: <http://www.clerus.co.uk/category/performance-review/>

In order to try and improve on this comparative metric we examine performance differences across the individual Schemes over 5 and 10 years using the metrics listed above as potential explanatory variables.

CLERUS' explanatory model is created using multiple regressions on all of the potential explanatory variables outlined in Table 1. As we intend to include only the factors that are statistically significant, we applied a stepwise regression by removing one-by-one those factors which had little or no explanatory power. This process continued until only two significant performance drivers remained. The result was achieved without any loss of explanatory power compared to a model using all 10 potential factors.

The final result of the regression process is summarised below in Table 2. R² or "R-squared" is the explanatory power of the model and the "Standard Error" a reflection of the prediction accuracy. This result means that more than 60% of the variance in reported annual performance over 5 and 10 years can be explained simply by looking at a Scheme's performance relative to its benchmark, with a further negative adjustment for the allocation to Alternatives³.

Table 2: Two-factor model showing the relationship between return on LGPS and (A) Performance relative to its benchmark and (B) Allocation to alternatives

Regression Period:	Annualised Absolute Performance over 10 Years		Annualised Absolute Performance over 5 years	
	Coefficients	Range of Coefficients with 95% Confidence	Coefficients	Range of Coefficients with 95% Confidence
Two-Factor Regression Model:	R² = 61%	Std Error = 0.55%	R² = 62%	Std Error= 0.65%
(R) Base return for LGPS universe	9.8%	9.5% to 10.1%	7.0%	6.7% to 7.4%
(A) Factor for performance relative to benchmark	90%	65% to 120%	70%	50% to 90%
(B) Factor for allocation (as % of AUM) to alternatives	-3.1%	-5.3% to -1.0%	-5.4%	-7.6% to -3.2%

Or simply:

$$\text{LGPS Return} = R + (A \times P_{\text{rel}}) + (B \times AA) \quad \text{where:}$$

R = Base return for LGPS universe

A = Factor for performance relative to benchmark

P_{rel} = LGPS performance relative to its benchmark

B = Factor for allocation (as % of AUM) to alternatives

AA = Weighting in LGPS portfolio as at 31st March 2013

Interpretation: Apart from explaining differences in performance due to these factors, a LGPS can also use this model to evaluate their own performance taking into account their own scheme specific asset allocation. For example a Scheme which returned -1.0% relative to its benchmark over 10 years and with an average 10% allocation to alternatives can calculate their adjusted peer-group benchmark performance as follows:

$$\begin{aligned}
 \text{10Y LGPS Predicted Annualised Return} &= R + (A \times P_{\text{rel}}) + (B \times AA) \\
 &= 9.8\% + (90\% \times -1.0\%) + (-3.1\% \times 10\%) \\
 &= 9.8\% - 0.90\% - 0.31\% \\
 &= 8.6\%
 \end{aligned}$$

³ Here the combined allocation to Private Equity, Infrastructure, Commodities including Currency and so-called Absolute Return Funds including Hedge Funds, Fund of Hedge Funds and Diversified Growth Funds.

CLERUS' first report revealed the £17.3 billion cost of advice to performance over the past 5 years, split between poor manager selection (£10.0 billion, -1.1%) and poor asset allocation (£7.3 billion, -0.8%).

The data provide us with statistics to evaluate the decision to allocate to alternatives across the LGPS sector as a whole. The difference in explanatory power of alternative investment allocation over 5 and 10 years is most likely due the increased allocation to this asset class from 1% to 9% (out of equities and bonds) over the past 5-6 years. At the same time we also observed some relationship between the factor for performance relative to benchmark and the factor for allocation to alternatives. This would indicate that an allocation into this asset class has also typically led to below benchmark performance even if in some cases benchmarks have been set at the low end of the spectrum.

How do individual factors impact on overall LGPS investment performance?

During the regression process, we observed some interdependence between the asset allocation variables and some other variables. This is intuitive, as reducing exposure to one asset class will typically mean increasing another. Some effects are contained in both factors even if the regression analysis has picked only the strongest. Another example of this relates to Investment management fees which are typically higher overall for funds with a high allocation to alternatives and is therefore a part of the explanation.

We will detail some of the most important factors on an individual basis in order of importance in the figures below. All charts include data as at 31st March 2013.

Figure 1: Strong relationship between performance relative to benchmark and overall performance

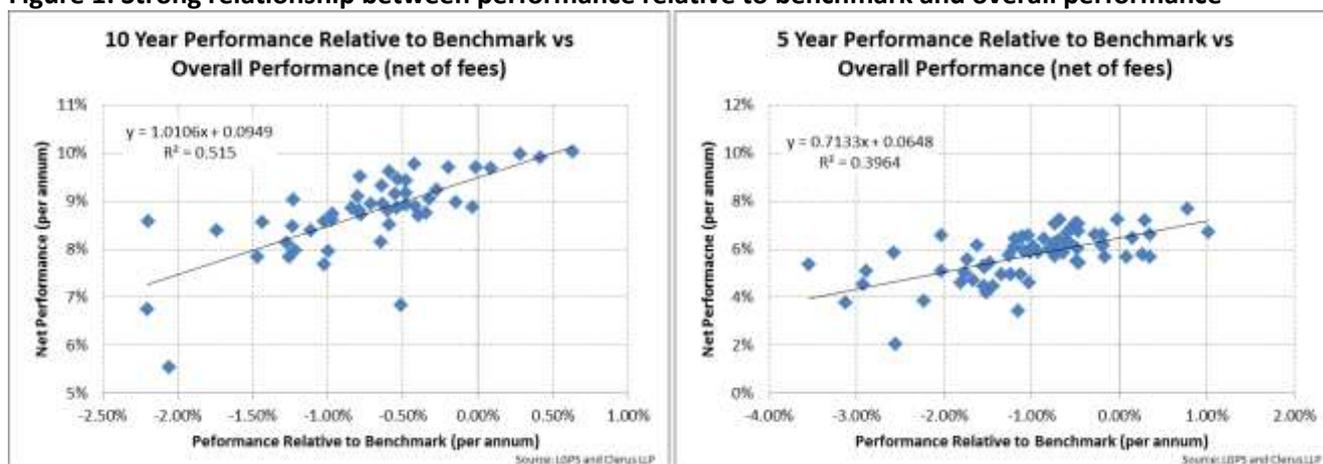
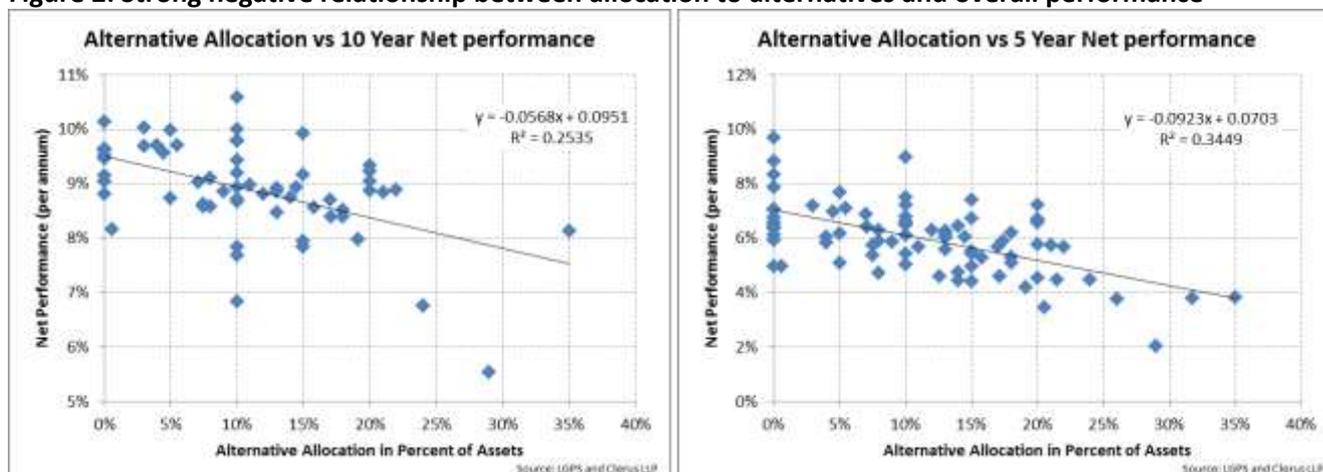


Figure 2: Strong negative relationship between allocation to alternatives and overall performance



Figures 1 and 2 illustrate the individual relationships between LGPS performance and the two strongest factors demonstrated by the regression analysis:

1. Over the past 10 years, about 50% of the variation in LGPS performance is explained by the performance relative to benchmark;
2. The decision to invest in alternatives has had a negative impact on overall performance. The significance of this factor has increased over the last 5 years.

Figure 3: Positive relationship between allocation to equities and overall performance

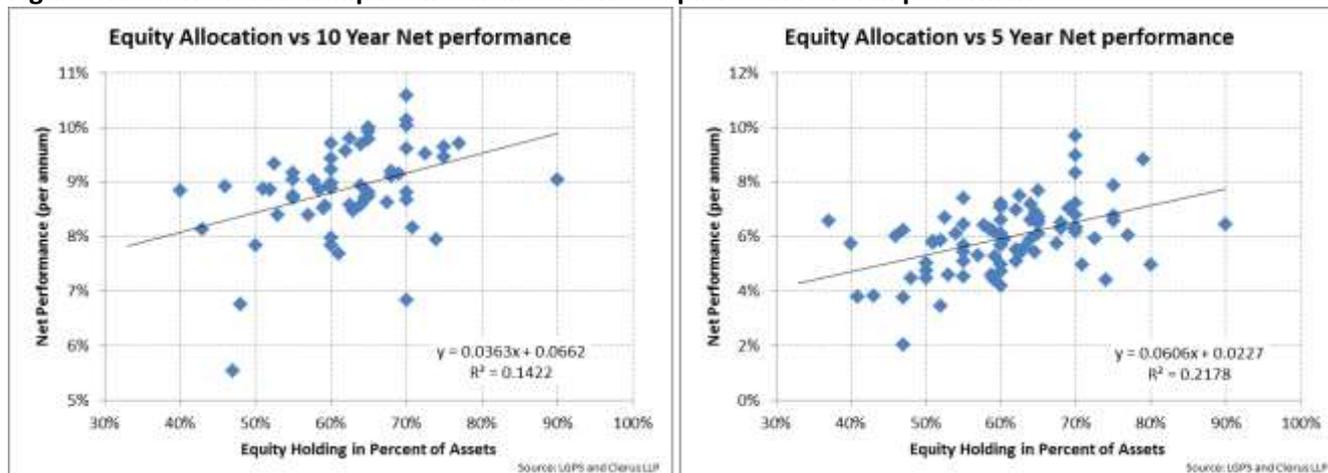
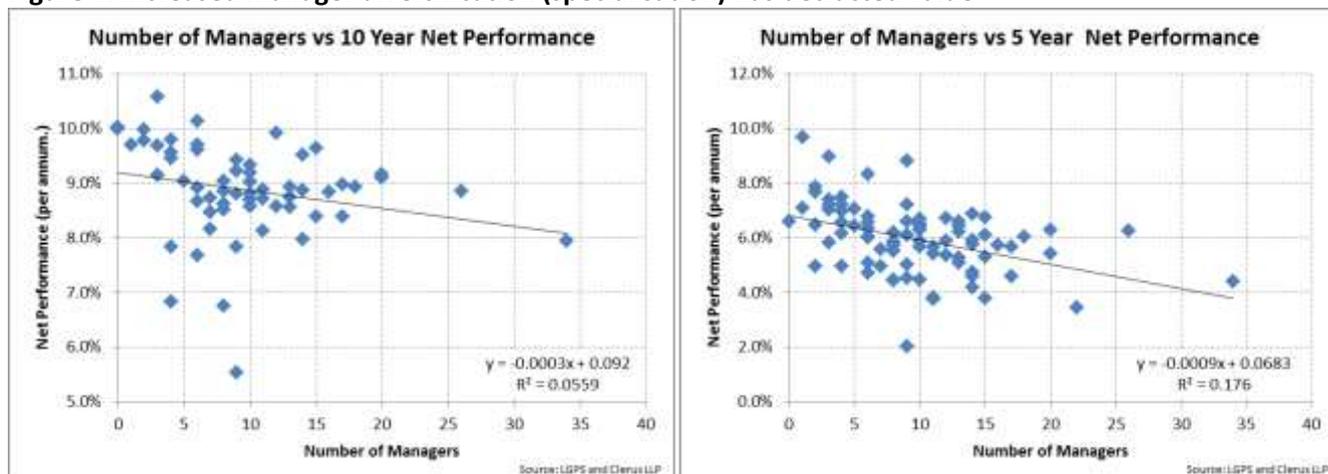


Figure 3 shows the observations for different allocations to equities, which have been the source for most of the allocation to alternatives: there is a good positive relationship between equity allocation and overall performance. This is intuitive and reflects the positive equity risk premium, which has been seen via rising equity markets over the past 5 and 10 years.

Figure 4: Increased manager diversification (specialisation) has detracted value*



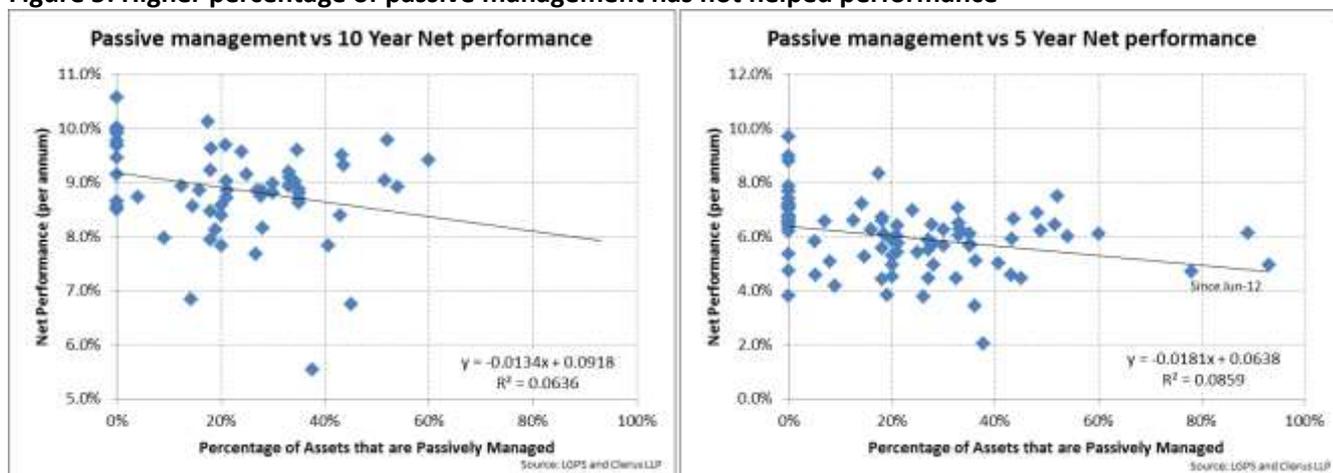
* In order to make the analysis relevant we have excluded a small number of schemes with 'in-house' teams investing with more than 50-100 external managers via pooled funds as part of their internal management process

Figure 4 shows a weak negative relationship between the number of managers and performance over 10 years with only 5% of performance explained by the number of managers. However over the 5 year period the negative relationship is much stronger explaining almost 20% of variance in performance or an average return reduction of 0.1% per annum per additional manager.

There has been an increase in the number of managers over the past 10 years, which Schemes' reports make clear has been driven by advice from investment advisers recommending additional 'specialist' managers. The downside is that this has increased the cost of selecting and monitoring managers but has not led to improved performance. This is intuitive because the effect of diversifying across a wider range of

managers means that Schemes are more likely to achieve index-like returns but at the cost of active fees. Conversely, if only a few active managers are selected, fees could be lower but an element of luck is introduced: active managers take more risk and a small selection may produce above benchmark returns.

Figure 5: Higher percentage of passive management has not helped performance



As part of the current LGPS consultation, consideration is being given to whether schemes should be 'forced' to adapt a higher percentage of passive management, while still being allowed to invest actively into alternative investments. It is therefore of interest to see if there has been a relationship between the percentage of assets that has been managed passively and the impact this has had on overall performance. If increasing the percentage of passive hedging is to be beneficial we would expect to see better performance from those Schemes which have had higher allocations to passive strategies and vice versa.

Unfortunately, as we can see in Figure 5, there is no such effect. In fact, over the past 5 and 10 years there appears to have been a weak negative relationship. In addition we observe a similar range of performance outcomes no matter the allocation to passive strategies. This would indicate that Schemes were targeting similar levels of active risk regardless of their allocation to passive strategies. This is a surprise as one would normally expect Schemes with more passive strategies to have a lower active risk budget and vice versa. We checked all LGPS to see if outperformance targets are typically reduced as the passive percentage is increased and find that for schemes with up to 80% in passive mandates, that this is not the case.

This would suggest that a higher level of passive management has been matched by more aggressive risk targets and/or investment for the remaining active and alternative allocations. The decision to move further up the risk curve with the smaller remaining active allocation has in fact led to higher losses relative to benchmarks, and has therefore produced similar or sometimes worse performance overall.

Exploring the Performance Impact of the Structural Factors

Some of the recent debate has included a discussion of mergers within the LGPS sector. There has been a suggestion that size matters and larger Schemes will produce higher absolute returns⁴, perhaps because there are some economies of scale from cost savings, a greater squeeze on external managers, or perhaps because larger funds perform better by managing funds internally. Lack of transparency in reporting has not helped this discussion because it has made it difficult to find comparable performance data, net of fees.

We decided to investigate further and the results are shown below.

⁴ See for example: "Do Larger Funds Perform Better?" State Street Investment Analytics – September 2013

Figure 6a: Pension fund size does not matter – Total performance

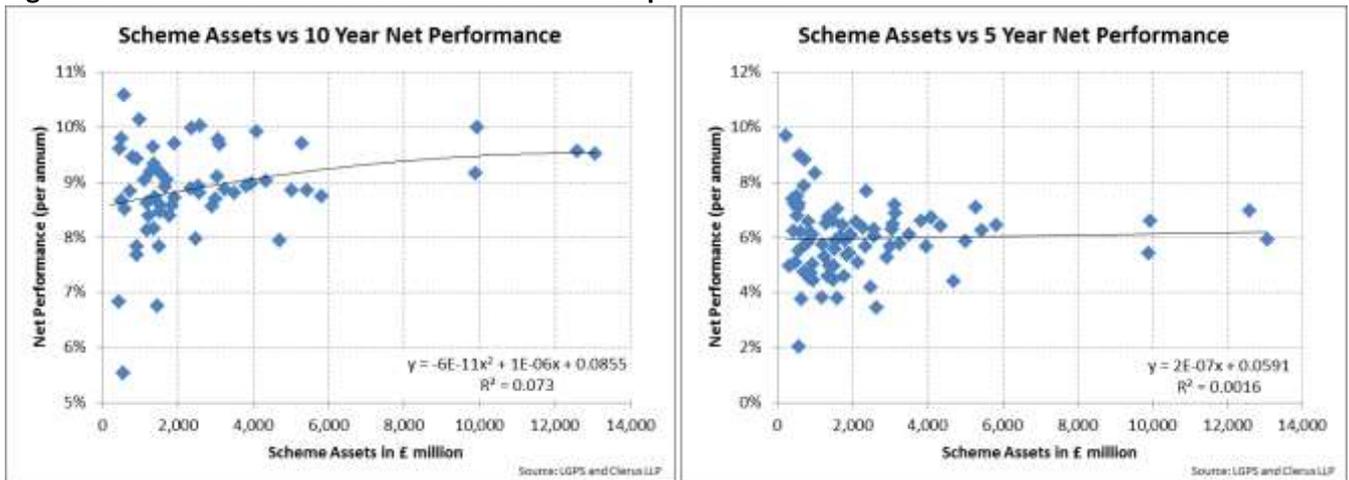
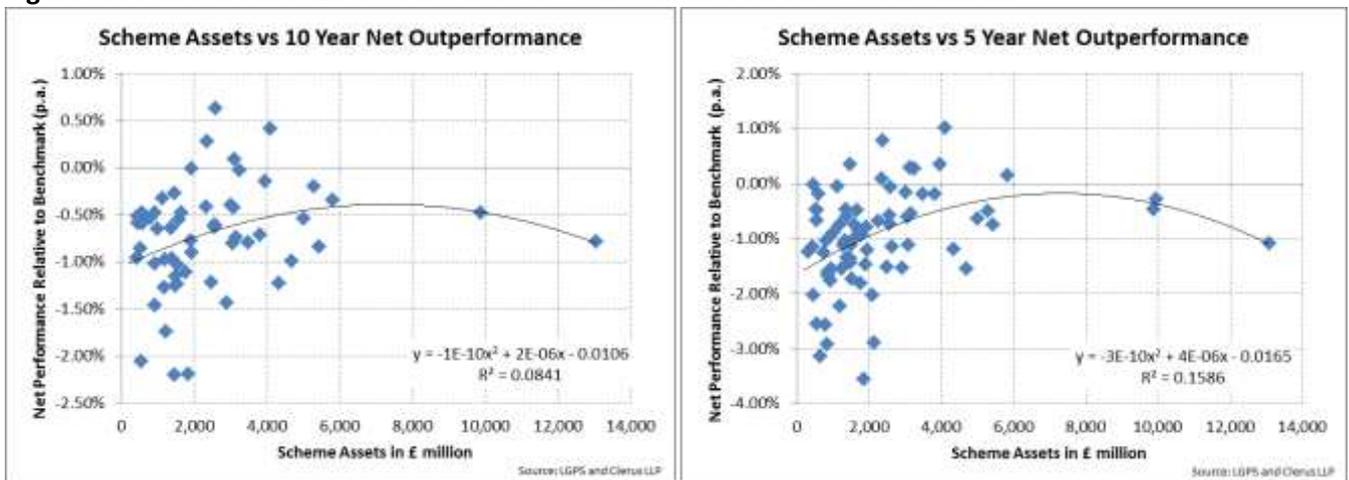
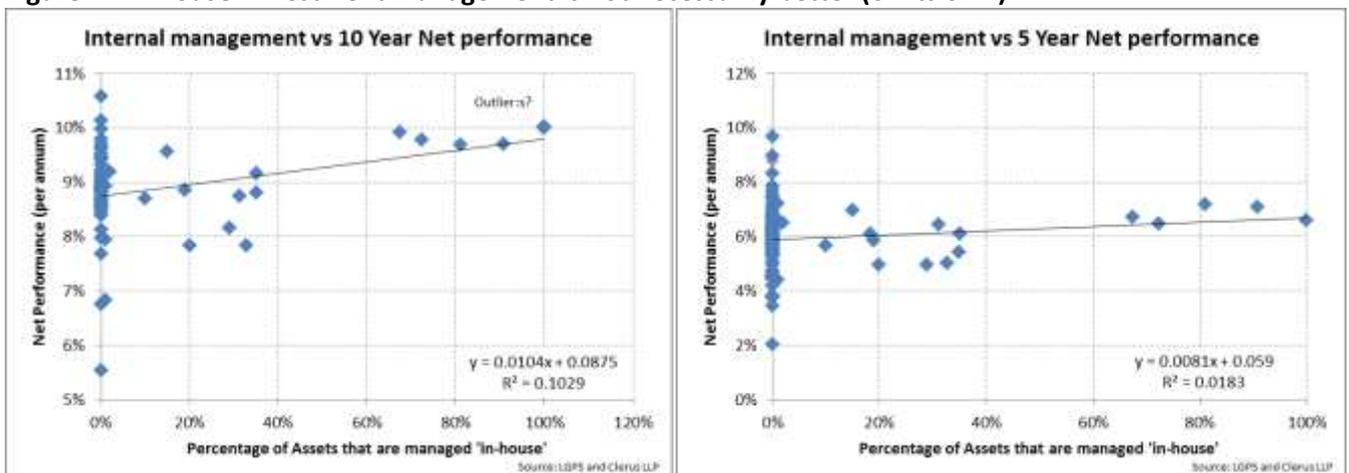


Figure 6b: Pension fund size does not matter – Performance relative to benchmark



Figures 6a and 6b examine whether large Schemes are better at producing higher returns and/or are better at manager selection than smaller Schemes. However the data shows no significant relationship between size and overall performance (Figure 6a) or performance relative to benchmark (Figure 6b). In fact some smaller funds (<£4 billion) have done well. This illustrates that good investment decision-making is not a function of scheme assets but of good governance, which is a factor, unrelated to size.

Figure 7: ‘In-house’ investment management is not necessarily better (on its own)



To help us better understand if the existence of ‘in-house’ expertise improves overall decision-making, we plotted the percentage of assets that are managed internally versus performance. The 10 year diagram is particularly interesting and would indicate that schemes with more than 60% of in-house capability perform better. Unfortunately, the statistical significance is low and close to zero over 5 years. Therefore we looked in more detail at why these Schemes might have outperformed, we found that:

- Four out of five schemes substantially comply with Myners on performance measurement
- Four out of five do not rely on investment consultants as sole input into the decision-making process
- Four out of five have had higher than average allocation to equities over 10 years
- Four out of five have had low, or below average allocation to alternatives over 10 years
- Four out of five have had better than average performance relative to benchmark, perhaps because by default they have had limited involvement with manager selection and rotation activities
- Four out of five have assets in the £2-5 billion category

All of these factors are consistent with our finding that good governance is good for performance. They are also aligned with the explanatory model presented in this report. We conclude that building in-house investment expertise can provide the foundation for better governance and investment decision-making although, on its own, it is not a guarantee of success.

Finally, we want to correct a potential misconception that ‘in-house’ management means that *all* assets are managed by internal teams. In reality, investment into some asset classes such as property and alternatives are invariably conducted by external investment managers via pooled funds. In extreme cases this can amount to more than 100 external managers - hardly an ‘internal process’. This results in additional fees that are not being reported in the investment management costs of the individual schemes.

Conclusion:

CLERUS’ research has uncovered the main drivers of overall investment performance amongst LGPS using a regression model, which mapped overall Scheme performance against 10 specific attributes. The model shows that more than 60% of performance outcomes can be explained simply by measuring the performance relative to benchmark (which is a proxy for manager selection activities) and then adjusting the number (downwards) for the percentage of assets allocated to alternative investments.

For the majority of Schemes, investment decisions have become little more than the implementation of the recommendations of their investment advisors. However neither the recommendations nor their impact are being measured or assessed by most Schemes (>90%). This means that there is a direct link to the governance issues we raised in our initial report vis-à-vis performance measurement as a pre-requisite for effective decision-making. This will make it difficult for local authorities to claim good stewardship of the schemes if the local pension fund committees continue to resist taking up these key Myners Principles.

Our analysis also evaluated the proposition that it might be beneficial to Schemes if they were ‘forced’ to adapt a high percentage of passive management, while still being allowed to invest actively into alternative investments. By focusing on investment outcomes rather than ‘cost-savings’ alone we were able to provide a broader perspective to this proposal. If past behaviour is a guide, then a ‘forced’ increase in passive management is most likely to lead to a further increase in risk via increased allocations into the alternative space. However our analysis highlights the risk of such a move further detracting from overall performance, thereby offsetting any potential cost savings identified by the Government⁵.

⁵ There appears to be a flaw in the December 2013 Hymans report to the Department for Communities and Local Government because it focuses on costs rather than performance outcomes, which is what really matter to the tax payer. In addition it appears that the potential cost saving of going passive may have been overstated in this report by £190m (0.11%) per year due to the double counting of the benefit of reduced transaction costs.

CLERUS agrees with the Government that LGPS reform is required. However we draw the conclusion that current proposals will not work as intended, unless the overall investment governance issues are addressed. In our view, the cheapest and most effective way to move forward would be making transparent performance assessment and reporting a regulatory requirement. This fills an essential gap between current practise and the good governance principles laid down by the Myners report in 2001.

Universe and Data Summary:

- 99 Local Government Pension Schemes in England, Scotland and Wales
- £208 billion in LGPS assets as at 31st March 2013
- Data sources: public data (annual reports, council committee minutes, etc.) going back 10 years
- Performance Data: 10 years (58 funds / 70% of Assets) and 5 years (74 funds / 84% of Assets)

Important Information:

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