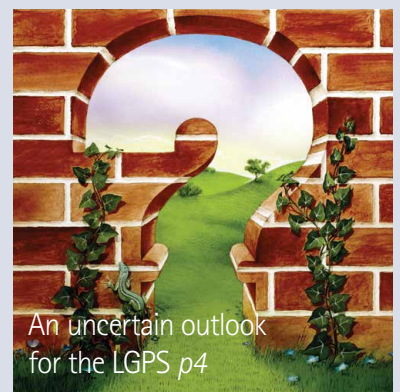
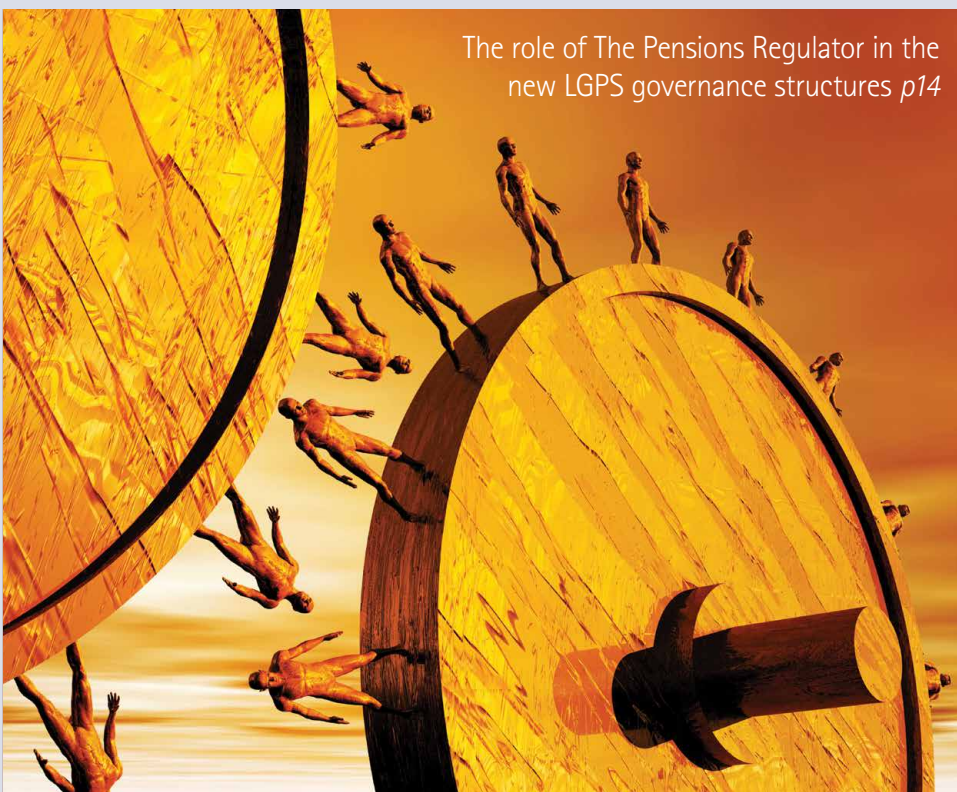


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## NIC PATON SUPPLEMENT EDITOR

As editorial consultant Terry Crossley has pointed out in this LGC Investment supplement, a very demanding 14 months or so lies ahead for the Local Government Pension Scheme and all those interested in it. First up, of course, will be the benefit changes introduced under the 2013 Public Service Pensions Act and coming into effect from April. This, as Terry has argued, can be seen as book-ending one the great periods of pension reform, starting from the Hutton Review recommendations. Yet, as lawyer Clifford Sims has also made clear, the act will bring with it a gamut of other new challenges and headaches for pension officers and administering authorities, not least the bedding down of the new career average contribution levels and needing to ensure the new governance structures and processes work smoothly.

Then, from April 2015, in an equally profound change under the act, we have The Pensions Regulator's new governance and administration standards taking effect. To that end, I'd recommend checking out our article by Bob Scruton, the regulator's head of public service pensions scheme regulation, which provides an all-too-timely roadmap of the role of the regulator in the new governance structures. Dorset CC's Paul Kent's examination of this same area is equally compelling, even if it is increasingly clear the new LGPS appears to be not just a puzzle, but the sort of puzzle you might pick up at a thrift sale: missing its box, lacking a number of vital pieces and needing extreme patience, stubbornness and (possibly) brute force to put together.

On top of all this, pension officers and their councillors are currently grappling with their 2013 valuation results, the impact of which Kent CC's Nick Vickers has examined in detail within this supplement.

Longer term, the climate remains one of uncertainty and volatility, making risk management – the identification, evaluation, control and (hopefully) mitigation of risk – a continuing priority, with Surrey CC's Phil Triggs showing how his authority's 'risk register' is helping to make a real difference. Managing volatility and risk management was also at the heart of our roundtable debate, in particular the pros and cons of absolute bond strategies and developing more flexible and dynamic portfolios.

Finally, and to return to Terry Crossley's analysis of the evolving political landscape around public sector pension reform, could it be the real 'elephant in the room' here is the May 2015 general election? I'm sure most LGPS interests will feel they've had their fill (and more) of reform and uncertainty since 2010, but a general election does have a tendency to concentrate minds of those both in government and opposition. Moreover, a new administration, even one of the same political hue – by no means a certainty this time around – invariably comes in refreshed, recharged and raring to make its mark (or at the very least keen to unravel or tinker with what has gone before). LGPS reform has come a long way, but let us not assume it's finally over yet.

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# Evolving political landscape

With a general election looming next year, a demanding 14 months or so lies ahead for the Local Government Pension Scheme and all those with a vested interest in it, writes **TERRY CROSSLEY**



**T**he prospect of a general election tends to concentrate the minds of ministers: what has been achieved; what has not been achieved; what remains to be done; is there a clear path to implement outstanding items within the Parliamentary timetable; and, most important of all perhaps, what can be quietly dropped, or sensibly modified, to get some semblance of a decent record card for the whips to submit to party managers?

Ministers with direct and indirect responsibility for the Local Government Pension Scheme will be doing all of that while their officials will be wondering how their political masters will shape up to the pressures before them and whether the business of effective government can be maintained. All too frequently, experience shows a corridor of uncertainty, and a form of policy diminishing returns lies ahead until early spring 2015, when politicians can turn to the hustings.

But before all that, much remains to be done. A very demanding 14 months or so lies ahead for all LGPS interests. The prospects of one full year and a bit means risks are to be identified and managed, important decisions and judgements must be made – and not just by ministers but by councillors, officers, advisers, fund managers and that vital LGPS ingredient on which so much depends, the consultant actuaries.

A brief litany of items caught

up in the reform agenda for public service pension reform started in 2010 by the coalition government makes for serious reading. To date, the completion of the 2013 act and the prospect of a coming into force in April of the 2014 LGPS benefit regime are the two solid achievements. But the inevitable flotsam and jetsam of the LGPS are still there.

The act is a direct descendant of Hutton and very much the creation of the Treasury and Cabinet Office, in their combined quest to centralise the classic local councillor-led stewardship of the LGPS. The future cost control of all public service schemes, by Treasury Directions, is further evidence of that policy, as indeed are the new governance requirements in the act, including a new statutory role for a national regulator.

As for the second achievement, LGPS 2014 does appear some way from Hutton in terms of its construct. While its 2014 benefit structure fits within the essence of Hutton and, where appropriate, the act, its conspicuous generosity and open-ended risks, particularly around the very favourable accrual rate, an open-ended 50/50 provision and significantly extended member contribution protections, seems more of a mid-point creation between Smith Square and Transport House, rather than Whitehall or even Victoria.

The emergence of informed views among administering authorities, post the 2013 valuations, suggests the

original 2010 ministerial/ Treasury expectation that the reformed LGPS post-2015 would be cheaper for employers and council tax payers, has effectively been foregone by a national and local political desire, ably supported by the trade unions, to rush to achieve a reformed but generous LGPS by April 2014.

The effect of that decision means a significant loss of previously assumed new income from members, which would otherwise have helped offset employers' increasing costs at a difficult budgetary and recessionary period.

This state of affairs is due to a failure to seek fair and sensible increases other than from poorly paid members, as recommended by Hutton and endorsed by government. So, contrary to other schemes, the 2014 LGPS begins its charmed life. But for how long many wonder, even though it should at least survive to the 2016 valuation. Whether the government's 25-year guarantee is ever likely to be achieved remains debatable.

It would be remiss to see that as the output of the great coalition pension reform agenda begun with a force and vitality not normally associated with the central department responsible for public service pension policy.

The corporate benefit reforms and particularly moving from final salary to career average terms were long overdue. A substantive proposition for the LGPS, as far back as 2004/05, to move to



CARE was sadly but firmly resisted by the trade unions and a significant number of fund authorities.

The introduction of a contribution tariff linked to pay was introduced in the 2007 LGPS under the previous administration. It allowed lower-paid members to be equitably catered for by increased but not overbearing (after tax) contributions from the higher paid. Undoubtedly, the 2014 reforms have gone further, with a state pension age link and CARE in

# e is key to pension reform



The possibility of a new political administration means the outlook for the LGPS is far from certain

particular, and the parallel consumer price index adjustment.

These modernising steps to cater for a 21st century local authority workforce, albeit a seriously diminishing one, aligned with strict cost control measures and assumptions in the hands of Treasury, are intended to ensure an affordable and viable scheme provision.

Just how both local authority and non-local authority employers react to their new contribution levels

from April 2014, based on the new benefit terms, and following the 2013 valuations, and increasing liabilities, remains to be seen.

The closing of the period of great pension reform has become increasingly clouded in the LGPS by a myriad of associated work streams thrust into germination in 2013. To some, the ministerial pronouncements seemed random, lacking in evidence at the outset and with scant policy analysis.

The most significant of them all, second-guessing Hutton's already agreed recommendation to encourage for partnership working, joint authority collaboration and joint procurement, seemed to many to listen more to the so-called academic experts, rather than to more honestly focus on the scheme's extant inherent strengths, its local democratic accountability and vital corporate experience.

The outcome of the studies and evidence gathering regarding future LGPS structures is expected shortly. Informed opinion suggests a move away from the extreme options preferred in Whitehall and, instead, towards Hutton's recommendation but with some additional flexibility, possibly leading to a CIV-style enabling amendment to the current LGPS investment regulations, to encourage greater local choice and investment collaboration in specific products.

Might it be that the scheme's distinctive

characteristics, so prominently put to Hutton's evidence-gathering exercise in 2010, are finally to be reaffirmed? Such an approach would leave intact the current statutory stewardship and investment decisions where they democratically best belong – at LGPS fund authority level.

A remaining element of the Hutton agenda has involved the implementation of the Public Service Pension Act 2013. Leaving aside the underlying sensitivities as to how Hutton arrived at his extensive chapter on governance, the challenges for the LGPS are not straightforward.

The Pensions Regulator's draft code of guidance is a helpful but essentially generic document. The Pensions Regulator, DCLG and expert professionals in CIPFA, the Treasurers' Societies and key practitioners should quickly prepare bespoke compliance material for pension fund authorities and others to be involved in the structures.

The commonly held view is Hutton's strictures for a locally administered and funded scheme were never going to apply sensibly to those concocted principally for centrally managed, unfunded schemes. Locally administered schemes like the LGPS, along with the Fire and Police schemes, pose difficulties not just for the regulator but also for DCLG, elected members and their officers.

To efficiently introduce the new governance requirements of the 2013 act across the

LGPS, the challenge remains to blend the role of elected members and their local stewardship role under extant local government and finance legislation, with the terms of the 2013 act and its newly prescribed administrative compliance role for the regulator, the Scheme Advisory Board and local pension board's fund authority advisory compliance roles. Hopefully upcoming DCLG draft provisions for consultation will offer a sensible, balanced framework for all these new roles.

Finding an equally sensible role for the LGPS Scheme Advisory Board will not be straightforward. Excessive expectations that the board should be somehow in practical control of the scheme, and even of fund authorities' pension assets, are misguided.

The 2013 act is very clear about the status and role of these boards. Treasury ministers publically recognised during the passage of the bill through Parliament that LGPS funds are not the same as those in private sector occupational schemes. Once that is accepted, the board should be able to get on with its advisory governance and cost control guidance tasks as specified by the primary and secondary legislative framework set by the government.

**Terry Crossley is former deputy director responsible for workforce, pay and pensions at the Department for Communities & Local Government and editorial consultant for LGC Investment**



# Solving the bond

Market volatility and risk management were key themes discussed at a recent LGC roundtable debate. **RUTH KEELING** reports

**G**iven the current low level of gilt yields, and the general expectation they will at some point rise, how can local government pension schemes protect themselves against capital losses when that uplift occurs and the value of fixed income assets falls?

One solution is absolute bond strategies, which look to manage portfolios through downside protection, or more flexible and dynamic portfolios that allow managers to try to tactically move around the bond markets identifying areas that are more lucrative.

At an LGC roundtable, organised in association with Pioneer Investments, a high-level group of local government pension fund advisers, committee members and practitioners discussed the pros and cons of such an approach – and attempted to discover the challenges local government funds face when considering such investment approaches. Different expectations regarding the impact of rising yields and the risks involved, different priorities between investment returns and liabilities and different levels of education and knowledge all came out in the discussion.

Some participants suggested funds may not need to worry so much about rising yields because the existing diversity of their investments, with perhaps just a fifth in bonds, meant their exposure was going to be limited.

Karen Shackleton, independent investment adviser with AllenbridgeEpic, said: “You are already protected against the full impact of a yield increase because only 20% of your portfolio is in bonds.”

For some, the risk attached to such strategies was simply too high. Deborah Hindson, director of finance at Newham LBC, said this approach took a “different risk strategy” from that adopted by her authority’s pension fund. “We have a 20-year Sterling index-linked bond fund... so we’re chipping away at our deficit, broadly matching liabilities and using this strategy to also generate some out-performance, which we feel is less risky.

“The fundamental issue for us is managing risk in the long term and we feel an absolute-return bond fund strategy for our fixed-income assets would bring more risk and more volatility. It is a significantly different approach, rather than our streamlined maintenance of index linking to protect our liabilities for our pensioners,” she added.

In response, Pioneer Investments’ David Green accepted that absolute-return strategies such as those offered by his firm are not suitable where a fund wanted to protect liabilities. However, he argued they could be used for the return-seeking part of a fund’s bond portfolio.

He also argued it would be a “shame” not to invest a portion of that bond portfolio into something that could give you a positive rather a



negative return. “If you know that you’re going to have 20% in fixed income over the next couple of years, why not shift 5% of it into an absolute return strategy?”

#### A solution

Absolute-return products, Mr Green added, offered transitional protection in this period before bond returns improved. Until then, and assuming bond returns are negative over the next one to three years, that meant 20% of the fund was returning -2%.

“That drags the rest of the fund down,” he said. “To our mind, even shifting a quarter or a half of that 20% into a strategy that will generate positive returns of 1%, 2% or 3% surely is a sensible suggestion.”

Some funds had seen and



grasped this opportunity, deciding to take a two-pronged approach to the problem of generating positive returns while still protecting liabilities. LGSS pensions investments group accountant Tolu Osekita explained that his two funds

# problem

“If you know that you're going to have 20% in fixed income over the next couple of years, why not shift 5% of it into an absolute return strategy?”



## AROUND THE TABLE

- Peter Scales (chairman)**
- Nick Buckmaster** chair of Waltham Forest LBC Pension Fund
- David Green** client portfolio manager, Pioneer Investments
- David Hanratty** head of UK and Ireland business, Pioneer Investments
- Deborah Hindson** director of finance, Newham LBC
- Tolu Osekita** group accountant, pensions investment, LGSS
- Karen Shackleton** independent investment advisor, AllenbridgeEpic
- Toby Simon** chair of pension investment committee, Enfield LBC
- Phil Triggs** strategic finance manager – pension fund and treasury, Surrey CC
- Kaye Wiggins** senior correspondent, LGC

**The pros and cons of absolute bond strategies and the challenges local government funds face when considering such investment approaches were discussed by the panel**

have taken this approach. “We are conscious of our liabilities and how we need to manage our assets to better match the liabilities, but we are also extremely conscious that we need to generate positive returns to improve our funding levels. So we have

split our fixed investment element of our asset allocation into two.” He added: “Can we suffer a -9% return on 20% of the portfolio when interest rates go up? No, we really can't. So we started to think about other ways to mitigate against

that – downside protection.” Despite the attractiveness of an absolute-return or more dynamic approach, there remained a concern local government funds did not feel confident and knowledgeable enough to adopt them. Toby Simon, chair of Enfield LBC's pension investment committee, said he was very keen for the fund to look at new approaches. “I am looking to take out the risk from the fact that bonds are a bit of a one-way bet at the moment; we've got to find other ways to invest our money to reduce our

exposure to the mark-to-market aspect of the bond part of our portfolio.” However, he also admitted that “exotic strategies like this, they can go wrong”. He said: “You have to understand what a strategy is doing and why it has stopped returning any money and why you have to get out of it. You have to be much more nimble.” Mr Osekita also felt that the governance requirements were “an issue”. A fund had to have the resources to take the

Continued overleaf



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time to understand what a manager was doing, the risks involved and whether a period of drawdown is to be expected or not.

“It seems eminently sensible for funds to be able to get the returns they need from their bonds allocation while still matching their liabilities, but the governance implications might overrule some of the benefits, especially for funds of a certain size.”

Even if fund officers have the capacity, understanding and confidence to use such products, members need also to be on board.

Ms Shackleton said absolute-return bonds and the investments they involved, such as swaptions, collars, steepeners and flatteners, to name a few, “are just overwhelming for a group of members who are lay people to understand. Ahead of any decision to go into absolute-return bond strategies, there has to be a significant amount of education and training.”

Education was not a one-off requirement, she emphasised. There would need to be “ongoing education and dialogue so that members feel they can keep on top of the strategy”.

**The ‘D’ word**

Part and parcel of this, especially when it comes to instilling confidence within local authority funds that this is a viable approach to be taking, is the fact absolute-return strategies are closely associated with, and use, the ‘D’ word – derivatives. Derivatives are, of course, still something of a dirty word within many financial circles (and were memorably described by American magnate Warren Buffett as “financial weapons of mass



**The majority of the advisers and practitioners were ready to sanction the use of derivatives to hedge investment risk**

destruction” a decade ago). Certainly, at the very least, this is likely to be an issue that would give high-profile, high-scrutiny local government funds pause for thought.

Local government funds, for one, cannot currently invest in derivatives directly, although some fund practitioners are lobbying the government for a change to the regulations. However, funds can invest in mutual funds that use derivatives, such as absolute-return bonds.

Despite their reputation, the majority of the advisers and practitioners gathered around the table were ready and willing to sanction the use of derivatives to hedge investment risk.

Nick Buckmaster, chairman of Waltham Forest LBC Pension Fund, said: “I love them. But I am a bit biased because I traded them and sold them.” He added: “With rising yields it will enhance your returns. Derivatives are great and I wish we could use them more.”

But others were less enthusiastic, and pointed out a pension committee that did not benefit from the



knowledge and expertise of a former trader might be less comfortable about exposure to derivatives.

Ms Hindson said: “It introduces another layer of challenge and complexity and makes the whole business much less transparent for members. You absolutely need to continue to invest in that learning and development strategy of the members, but even if you do it can still be very complicated.

“If you can secure protection against your liabilities and pension fund management [by other means], why would you need to do that [with derivatives]?”

“We don’t all have backgrounds in that area, we are very heavily dependent on what our advisers and managers are saying. Our members need to understand

it and take their own view on a rational, evidenced basis,” she added.

Phil Triggs, Surrey CC’s strategic finance manager – pension fund and treasury, agreed. His pension fund board, also chaired by a former banker, was due to discuss the use of derivatives at its next meeting, but he argued fund board members with a different background might be less willing to do the same.

Ms Shackleton, another derivatives fan, agreed both derivatives and their complex use within absolute-return products were “not right for everybody”. She added: “It is down to the governance capability of the people whose responsibility it is to make sure nothing goes wrong.”

“That is probably the main reason why absolute-return



“One of the most important things you can have when talking about an absolute-return strategy and derivatives is a very, very robust risk management process

has not taken off the way you might expect. There are other ways to protect against the risk in yields rising, quite simple ones, like going overseas or into high-yield.”

But those without an insider's knowledge of complex products should not shy away from using them completely, according to Mr Osekita, who argued that funds should avoid micro-managing.

“There are some things we don't necessarily need to be experts in,” he said. “Our focus should be on the high-level strategy – what we are trying to achieve as an objective – and then be able to delegate the implementation of that to the right manager, leveraging that manager's capabilities and monitoring the performance and risks on a regular basis.”

Picking the right manager was key in relation to dynamic products such as these, and in particular the attitude and practice of that manager to risk management, according to Mr Green.

“One of the most important things you can have when talking about an absolute-return strategy and derivatives is a very, very robust risk management process,” he said.

“I would urge anybody looking at these products, as much as you check out the portfolio manager and whatever he does, check out the risk management process as well – very, very important,” he added.

#### **No delay**

Taking into account all of the risks and governance and education requirements, the feeling was that funds should examine the possibilities. Mr Green said this should happen “sooner rather than later” because the approach would only be of benefit during this transitional period in yield rates.

He predicted bond yields would rise in the next 18 months, giving funds a limited window of opportunity. The rise in bond yields that had occurred in mid-2013 had already given people sufficient warning “to bring the discussion to their boards”, he said. In fact enquiries about absolute-return strategies had gone “sky high” at that point, he added.

The need to act relatively swiftly applied even to funds that were not racing to embrace such solutions, Ms Shackleton argued.

“Pension funds should have this on their agenda now. Even if, following that discussion, they decide that they are happy with the bond strategy they have got, they should have this on their agenda. It is not something to delay,” she said.

## COMMENT

JONATHAN MAY, head of institutional business development, UK, Pioneer Investments



# Absolute-return bond strategies – how they work

Given some of the concerns raised at our LGC roundtable regarding lack of insight into absolute-return bond strategies, it is perhaps helpful to explain our approach.

Absolute-return bond strategies are designed to generate positive returns whether markets rise or fall. To be successful, we believe they need be able to access multiple sources of alpha, have the ability to run negative duration and have a strong risk management framework.

#### **Alpha generation**

At Pioneer Investments, we split the portfolio into a core component and then the alpha strategies. The core strategy is built to replicate a reference rate close to cash. The remainder of the portfolio is the alpha strategies. The objective is to generate returns above cash.

We use a globally diversified range of 15 to 20 strategies. These strategies include interest rate duration, sovereign spreads, interest rate relative value, volatility, inflation products and foreign exchange.

All are managed by highly experienced specialist portfolio managers and are implemented primarily through liquid derivatives. We believe this is an efficient way to gain exposure and it allows the managers to take short positions, which means the strategy has the ability to

decouple from the market trend. For example, rather than have rising rates erode the value of bond portfolios, a manager can take a negative duration position.

#### **Risk management**

But the emphasis for the alpha strategies is really on taking small amounts of risk across many uncorrelated positions. And because of their low correlations, the combination of alpha strategies should lead to lower volatility and risk.

Working with the portfolio managers is the portfolio construction team, dedicated to optimising risk-adjusted returns. They monitor correlation patterns among the strategies, with the objective of ensuring a sufficient range of alpha sources to avoid one single manager or position dominating the performance and/or risk.

With bond investors facing serious challenges as yields rise, we believe UK pension funds should consider an allocation to an absolute-return bond strategy. To do nothing or even continue with fixed income strategies, we believe, could lead to considerable losses over the coming years.

• To find out more about absolute-return bonds and other alternative fixed-income strategies, please contact [jonathan.may@pioneerinvestments.com](mailto:jonathan.may@pioneerinvestments.com)

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# Surrey uses risk management

**PHIL TRIGGS** explains how Surrey CC's risk register is making a real difference to its pension fund



**P**rogress always involves risk; you can't steal second base and keep your foot on first. So said American journalist and humourist Robert Quillen (although it is also widely attributed to US author and baseball aficionado Frederick B Wilcox). In order to progress properly, a Local Government Pension Scheme fund must adopt the above mantra and learn to operate effectively within an environment of certainty and uncertainty.

Concerning risks known to the LGPS manager, in other words the 'known knowns' a solid framework of risk management is required in order to manage the considerable risk exposure surrounding the governance and investment of the pension fund.

Every pension fund should keep a risk register. Surrey Pension Fund has a very comprehensive schedule, detailing the known risks. The risk management policy of the Surrey Pension Fund is to adopt best practice in the identification, evaluation and control of risks in order to ensure they are firstly recognised, and then either eliminated or reduced to a manageable level. If neither of these options is possible, then means to mitigate the implications of the risks should be established.

Surrey's risk register has 36 current known knowns. Surrey's number one risk, in terms of impact and likelihood, is longevity. Longevity risk refers to the risk

that actual survival rates and life expectancy will exceed expectations or pricing assumptions, resulting in greater-than-anticipated retirement cash flow needs.

The most common school of thought is that people will continue to live longer, although the rate of increase – which has been around two years per decade for some time now – may slow down. Significant future advances in medical science may result in a further jump ahead. All else being equal, contributions will need to increase in future if people continue to live longer.

Later retirement ages will certainly mitigate some of the cost but it is thought by our actuary that the increases in retirement age that have been scheduled will not keep pace with the increases in life expectancy. Moreover, there is also some evidence that suggests individuals who work for longer tend to live longer also, as this keeps them healthier.

Number two on the list is real interest rate risk, that is, the real rate allowing for inflation. A fall in gilt yields will lead to an increase in the value of liabilities: a 0.1% reduction in the discount rate increases the liability valuation by 2%. Surrey's discount rate in the 2013 triennial valuation was 4.6%, down from 6.1% in 2010.

Some would call this prudence, others might call it self-harm. Regardless, the stance reflects current market conditions and the flight path to full funding will assume some benefit to gilt yields



# ent know-how



Surrey Pension Fund weighs up its risks with a detailed risk management policy

“Surrey’s risk register has 36 current known knowns. Surrey’s number one risk, in terms of impact and likelihood, is longevity

returning to more normal levels over the next few years.

Number three is pay and price inflation. An increase in CPI inflation by 0.1% will increase the liability valuation by 1.4%. Unlike normal debt, a ‘healthy bit of inflation being a good thing’ certainly does not apply to pension fund liabilities. High inflation is the LGPS manager’s enemy and its level and effects need to be anticipated and controlled.

Given these three risks are at the very top of the register will imply that steps are taken by Surrey to manage them. The need for relief from liabilities exposed to longevity risk has created an emerging market with innovative market-based risk transfer solutions. There are three broad longevity risk transfer mechanisms: a buy-out; a buy-in; and a longevity swap.

Additionally, securities (such as longevity bonds) and indices may emerge to facilitate longevity risk hedging. The idea is not necessarily to hedge against this risk, rather the process brings a degree of certainty to the actuary’s liability valuation. Conversely, there are some LGPS managers who would

Continued overleaf

## COMMENT

DON JORDISON  
Managing director, property,  
Threadneedle Investments

**threadneedle**  
investments



## UK property recovery to continue in 2014

At the beginning of last year, we forecast the market would recover and this proved to be the case. UK commercial property returned 10.9% in 2013, according to the IPD UK Monthly Property Index, its strongest annual performance since 2010. Returns improved steadily throughout 2013 as wider macro-economic conditions improved and confidence subsequently grew in assets outside of prime or central London locations.

Having anticipated this development, we spent the year gaining exposure to the sector. But we now face the question of whether the strong performance seen in 2013 can continue. We firmly believe it will. The factors that drove the market’s advance in 2013 are still in place, while new sources of support will also come into play.

Last year, our optimism was based on various key themes we had identified:

- The property sector has a very high relative income return to other asset categories
- It remains a good hedge against uncertainties in bond markets
- The improvement in the banking sector balance sheets led to an easing in the difficult financing conditions seen in recent years and that improvement is continuing

During 2013, there was growing demand from institutional investors in property, driving up capital

values. This was underpinned by greater risk tolerance and confidence in the UK economic recovery, resulting in demand for shorter leases and interest in property outside of prime or central London locations.

As we enter 2014, there are a couple of extra tailwinds:

- We have never emerged from such a deep recession with such good supply fundamentals
- The improving economy should boost consumer spending, helping the high street, out-of-town developments and supporting rental income from these areas

So, what do we believe are the greatest risks to the market in 2014?

The rapidly improving economy and a reduction in central bank support, could lead to interest rate rises and adversely affect the benign financial environment that has allowed UK banks to manage their excess exposure to commercial property loans.

Rising gilt yields could encourage asset allocators to return to the sector. As gilt yields rise above the 3% level the relative attractiveness of property may subside. Finally the possibility of another setback in the eurozone, perhaps centred on France, could spook asset allocators. Overall, however, we are optimistic about the outlook for 2014.

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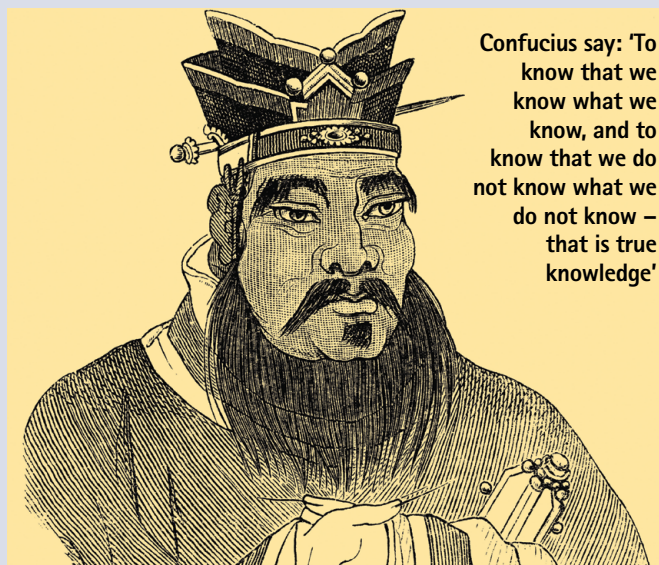
proclaim that the unknown unknowns out there, yet to happen, will at some point over the next 100 years make the need for this type of insurance completely superfluous. Pension costs will be controlled by future unknown events, so why throw money at it now?

With interest rate risk, Surrey is currently considering converting some of the passive physical equities into a synthetic equity structure using derivatives, which will free cash to start developing a portfolio of assets that provides some real interest rate protection.

A key attraction of such an approach is that the expected return on the assets would be expected to remain broadly the same (given that the exposure to equity markets would not be reduced), while providing a mechanism to reduce liability-related risk and provide better control of the deficit, and hence help manage the affordability of employer contributions.

Another key attraction of such a structure is that it would allow the fund to be more dynamic and reduce risk on the flight path to full funding when conditions are attractive to do so in a timely way. For example, if the funding level improved, to say, 90% plus, the attraction of reducing risk would arguably be worthy of serious consideration.

It is time to set up such a structure, given the level of training and due diligence required (nine to 12 months is a reasonable expectation), so looking at this now could put the fund in a better position where it could react relatively swiftly to capture what would be considered attractive de-risking opportunities in



“Without the ‘building blocks’, opportunities to de-risk at the right time are going to be very difficult to capture in a timely manner

the future. Without the appropriate structure in place, the opportunity to de-risk when attractive could easily be missed.

The implementation of such a structure will need to be carefully considered, especially given that the rules on the use of derivatives is open to interpretation. But we see no reason why this should be a barrier to considering such an approach, given that some other LGPS funds have liability risk management strategies in place. As part of an investment strategy review, there are other areas that also deserve attention, such as reviewing the structure of the growth assets, and considering how infrastructure might fit in.

With regard to inflation risk, this is a conundrum. There is a massive supply and demand imbalance for inflation-linked gilts, which are the best match for inflation-linked liabilities, particularly relevant for LGPS liabilities.

There is an estimated £1.2 trillion worth of inflation-linked defined benefit liabilities in the UK with about £430bn worth of index-linked gilts and swaps in issue/ transacted, so it's reasonable to say that there is at least three times more potential demand than supply of inflation hedging assets. Issuance of new index-linked gilts is expected to fall over the next couple of years, so it is unrealistic to expect the supply side of the equation to address the imbalance.

This is expected to result in long-term technical pressure on the pricing of index-linked assets. Market volatility, however, is likely to mean that there will be ‘relatively’ good opportunities to implement some hedging. Again, the fund will need to have the appropriate arrangements in place to capture opportunities as they arise with such a strategy forming a key part of trustee training.

So, the overall theme of the review is to identify ways of diversifying the assets to help get the return needed to make up the deficit but to also invest in a more risk aware manner versus the liabilities.

It is important to note Surrey is not going to be hedging everything. It is more

about getting a small amount of protection in place, which then forms the building block for being able to take more risk off the table as and when the funding level improves. Without the ‘building blocks’, opportunities to de-risk at the right time are going to be very difficult to capture in a timely manner. We want to be in a position to do this without stress and strain. Of course, prior to any decision making, effective training in respect of all these solutions is paramount for the Surrey Pension Board members.

In this article, we have looked at just three risk – the big ones, categorised in the known knowns category. But what about the unknown unknowns, by definition, not listed or quantified?

It is often said the next crisis is something not yet thought of. These events are also referred to as ‘black swans’ and we have seen plenty of them over the past six years or so. Trying to identify all the black swans will not prepare us for the one that strikes – there are just too many of them.

LGPS managers need to accept bad events happen occasionally, and to make sure we can weather them, no matter where they come from. Even better, be prepared to benefit from the occasional black swan.

The difficulty with unknown unknowns is that there is no quantitative or qualitative analysis. We can't measure or describe. It could therefore be said that unknown unknowns, even though they will significantly affect our fund and future investment strategies, are nothing to do with risk management.

Maybe the last word here should go to Confucius: “To know that we know what we know, and to know that we do not know what we do not know – that is true knowledge.” **Phil Triggs is strategic finance manager at Surrey CC**

## COMMENT

ANA HARRIS

Portfolio strategist, global equity beta solutions group, State Street Global Advisors

STATE STREET GLOBAL ADVISORS®



# Advanced beta comes of age

Interest in advanced beta has grown significantly over the past few years, especially since the launch – more than 10 years ago – of mainstream indices to capture factor exposures such as value or low volatility. These strategies represent an evolution in indexing or passive equity management. Investors are no longer constrained by the active versus passive debate because these strategies bring the best of both to the fore.

### A brief recap

Decades of academic research show that strong long-term performance results are achievable by diverging from investment weighting schemes centred solely on market capitalisation. These new strategies and products are known as advanced beta, or sometimes smart or alternative beta. In most cases, the definition itself is pretty consistent: an objective, consistent, transparent process for capturing a defined investment exposure. Characteristics, that make them ideally suited for passive implementation.

SSgA recently commissioned Longitude Research to conduct a study into what investors think about advanced beta and how they are planning to include it in their portfolios. Respondents included public and private pension funds, endowments, foundations, insurance companies and private banks, across both Europe and North America.

One of the key findings was investors' views on advanced beta are generally positive and becoming more so. In Europe, 42% of the participants had already invested in advanced beta and a further 22% were intending to do so. Only 20% of participants professed scepticism about the approach.

While in Europe, the majority of the private pension schemes in this survey had already committed a proportion of their portfolio to advanced beta, the figure for public pension schemes was significantly less. This looks set to change, however, given that fully 57% of the European public schemes surveyed said that they intend to invest in advanced beta.

### Allocation to advanced beta

The empirical evidence and the potential for positive excess returns relative to the market over the long-term is attractive to investors. The ability to reduce risk at overall portfolio level from strategies

like low volatility and quality are also appealing.

In order for an allocation to make an impact it needs to be significant and most investors appear to realise this. Looking at the institutions that have already allocated to advanced beta, the majority have between 11 to 15% of their equity portfolio in these strategies. Our survey results suggest these allocations will increase in the coming years.

When they're considering their allocation, investors will tap into their current active and passive allocations to fund their advanced beta strategies. Indeed, when asked about their future allocations, 63% of the institutions in the survey will be funding their advanced beta allocation from both active and passive. The second most popular answer was to fund it from their active allocation (28%), with only 8% intending to reduce their passive allocation. The breakdown was similar when looking at either private or public pension schemes, Europe or US.

### Expanding opportunity set

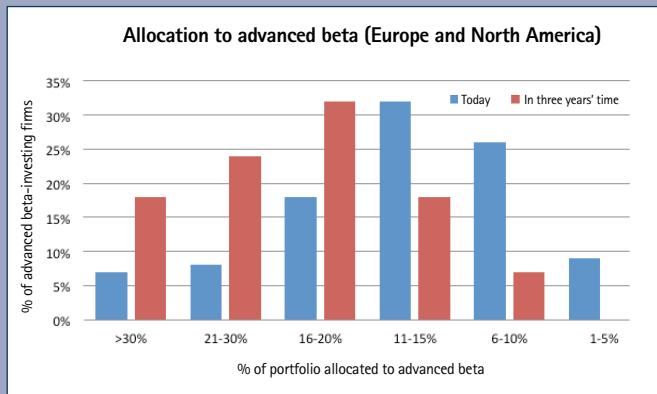
Low volatility and low valuation strategies have been the most popular so far, but there is a lot of interest in quality as a future allocation. Multi-factor strategies are also increasingly on the radar of most investors; 71% of the interviewees in Europe were currently investigating multi-factor strategies with a view to possibly investing in the future.

Looking only at pension funds in Europe, we observe a similar trend with regard to multi-factor but there is also interest in income. Around 55% of the public and private pension schemes in the survey are currently investigating the possible use of yield-based advanced beta strategies.

### An advanced future

Investors appear to be focusing more on outcomes than merely investment styles. The empirical evidence is strong, growing and consistent. There are also now live track records that investors can refer to when considering advanced beta. Investors need to be mindful that these are investments for the long term. They need to build strong support and awareness within investment committees and the broader stakeholders for a truly successful implementation.

One thing is certain though – these strategies will continue to develop further and challenge the status quo. ● Download your copy of the report at [www.ssgainsight.com](http://www.ssgainsight.com)



Source: SSgA, Longitude

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# What will The Pensions Reg

**BOB SCRUTON** provides a timely roadmap of what we can expect the regulator's role to be in the new LGPS governance structures



**T**he Pensions Regulator was given an expanded role in the Public Service Pensions Act 2013 in respect of the governance and administration of public service schemes.

From April 2015, the regulator will set standards of practice in this area for local government, the NHS, teachers, the civil service, armed forces, police, firefighters and the judicial pension schemes.

Between them, these schemes represent about 12 million members – of which some five million are active – and more than 22,000 employers.

The 2013 act followed a report by the Independent Public Service Pensions Commission in 2011 that made recommendations aimed at ensuring public service pensions would be sustainable and affordable in the future, while also providing an adequate level of retirement income for members.

The reforms are intended to reduce and control scheme costs. Each scheme is being redesigned with this aim. The 2013 act provides for clearer governance with specific defined roles, the provision of benefit information on a consistent basis, and administration practices that are broadly in line with those in the private sector.

Some of the requirements include:

- Information to be provided to members about benefits
- Information about pension

boards to be published

- Members of pension boards to have knowledge and understanding of their scheme rules, their scheme's administration policies and pensions law
- Reporting of significant late payment of contributions to schemes
- Scheme managers to establish and operate adequate internal controls and keep specified records

### **Good governance and administration**

Good governance and administration should improve the efficiency of public service schemes and will result in their being more cost-effective for employers, including the government departments responsible for the schemes. The size and number of memberships of many public service schemes means they can face many challenges including maintaining high-quality data and records.

The regulator recently consulted on a draft code of practice providing practical guidance to help public service pension schemes to meet the governance and

**“**As in the private sector regime, certain investigative and enforcement powers apply to anyone involved in the administration of a scheme

administration requirements that are set out in legislation.

The regulator also consulted on a draft regulatory strategy, which describes how it will educate and enable those involved in governing and running public service schemes to assist them in complying with the law and meeting the standards of practice outlined in the code. The draft strategy goes on to explain that, where necessary, the regulator will be able to take enforcement action to ensure the underlying legal requirements are adhered to.

To implement the strategy, the regulator will continue to work to understand the risks across public service schemes, develop and communicate policies that set out good outcomes and what schemes should do, and determine how best it can use its regulatory tools to mitigate any risks.

The regulator is currently reviewing the responses to the consultation on the draft code of practice and draft regulatory strategy and will report on them shortly. For Northern Ireland there will be a similar consultation exercise once the necessary legislation is in place.

### **Areas of focus**

The draft code sets out practical guidance, the underpinning legal requirements and standards of conduct and practice for scheme managers and pension boards in four core areas of scheme governance and administration.

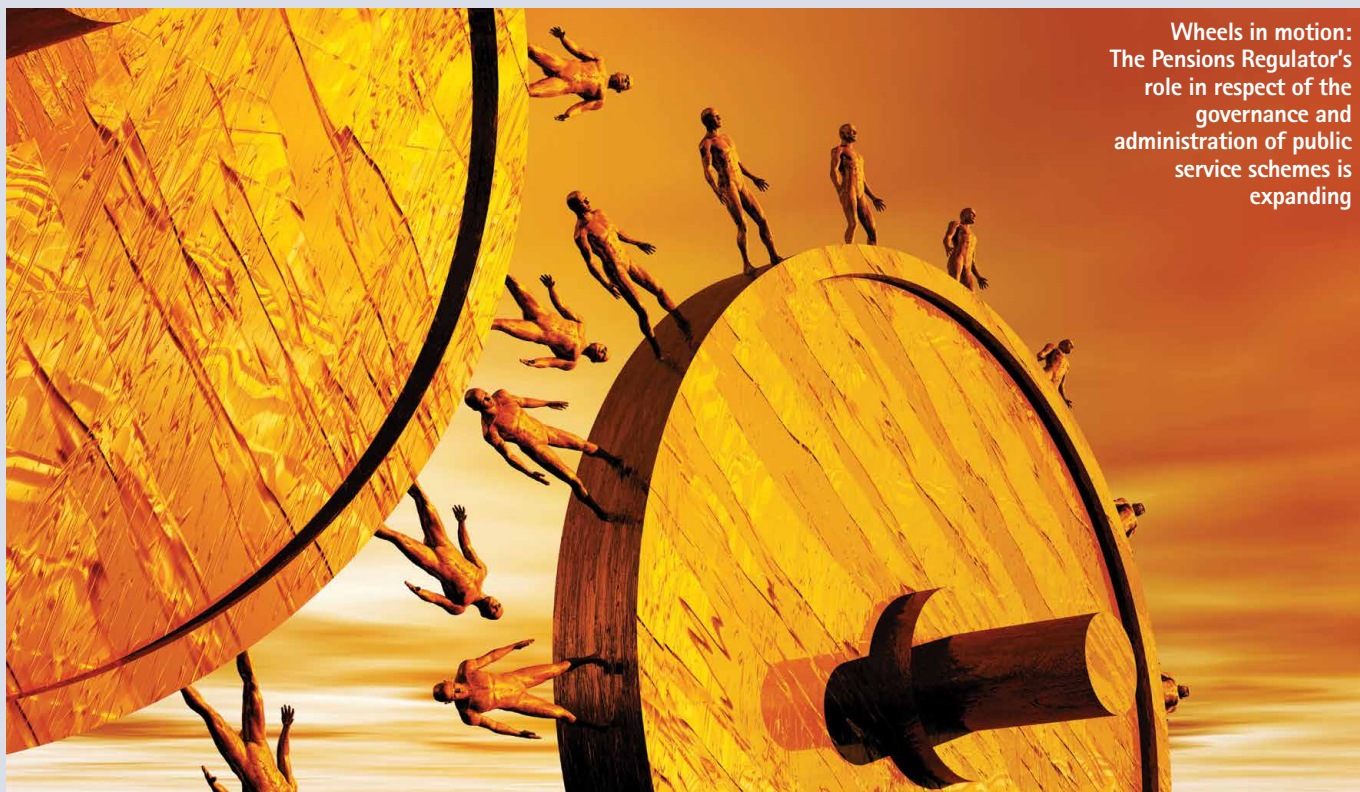
‘Governing your scheme’ covers areas such as knowledge and understanding required of pension board members, conflicts of interest, and information that must be published about schemes. It sets out the legal requirements in this area, such as members of the pension board being conversant with the rules of the scheme and having knowledge and understanding of the law relating to pensions.

Conflicts of interest is a subject covered in some depth, with assistance in identifying, monitoring and managing potential conflicts, as well as providing examples of when they can arise.

‘Managing risks’ outlines the need for scheme managers to establish and operate adequate internal controls. It sets out the legal requirement to have systems, arrangements and procedures in place for the administration and management of the scheme, and for monitoring the administration and management, as well as for the safe custody and security of the assets of the scheme.

‘Administering your scheme’ covers scheme record-keeping, maintaining contributions and information that must be provided to members (such as benefit statements). It refers to the records of information relating to member information, transactions and pension board meetings that scheme managers must keep.

# Regulator's role be from 2015?



**Wheels in motion:**  
The Pensions Regulator's  
role in respect of the  
governance and  
administration of public  
service schemes is  
expanding

Failure to maintain complete and accurate records and put in place effective internal controls to achieve this can affect the ability of schemes to carry out basic functions. Poor record-keeping can result in schemes failing to provide accurate information to members, processing incorrect transactions and ultimately paying members incorrect benefits.

'Resolving issues' includes information on internal dispute resolution arrangements and whistle-blowing. Scheme managers are required to make and operate dispute resolution arrangements, which comply with the requirements of the law and support the resolution of pension disputes between the scheme manager and a person with an interest in the scheme. Scheme members expect their

pension scheme to be managed effectively.

Where a person with an interest in the scheme is not satisfied with any decision made that affects them, they have the right to ask for that decision to be reviewed.

#### **Putting things right**

Although there are a number of differences between public service and private sector schemes – most obviously that the former are statutory – they face many of the same challenges.

We will take a similar approach to regulating them – prioritising education and enablement but taking enforcement action if necessary to make sure schemes are run to a high standard.

Where we, schemes or others identify a problem our main aim will normally be to

work with the scheme to ensure it is remedied.

As in the private sector regime, certain investigative and enforcement powers apply to anyone involved in the administration of a scheme, including third party administrators, where that is more appropriate.

The regulator's powers include requiring information and publishing reports. Enforcement action would depend on the circumstances of each case but could include directions to carry out certain tasks, for example rectifying gaps or errors in member records using 'improvement notices' or 'third party notices' under sections 13 or 14 of the Pensions Act 2004, and penalties for failure to comply.

#### **Next steps**

The schemes concerned are currently concentrating on

the benefit redesign element of the reforms, and the regulator is engaged with them on the administrative requirements and the new governance arrangements.

We will continue to engage with the schemes and other interested parties to understand them and their issues better, and as we near April 2015 we will be building up our regulatory team. When the new regime is in place we plan to review and report on the progress of public service schemes each year.

It is anticipated that the final code of practice will be laid before Parliament in the autumn of 2014. For further information please visit the regulator's website: [www.thepensionsregulator.gov.uk](http://www.thepensionsregulator.gov.uk) **Bob Scruton is head of public service pensions scheme regulation at The Pensions Regulator**



# Valuation fever

**NICK VICKERS** considers the impact of the 2013 actuarial valuation results and the implications for local authority funds



The actuarial valuation results are out – but keep it quiet. In ‘normal’ times there are surveys and articles and much excitement, but this year feels different. Everyone seems to be keeping their heads down, even those actuaries who must get a bonus for the number of times they get quoted in the national press, and I think there are a number of reasons for this.

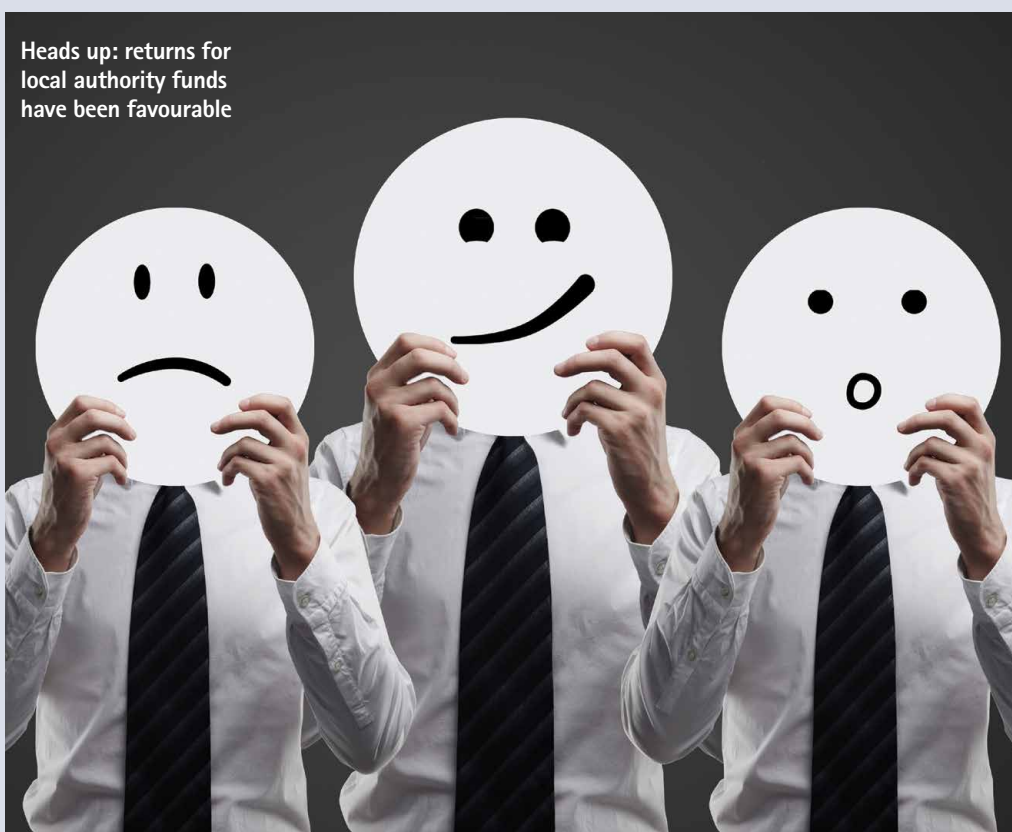
Firstly, I think everyone has too many other things to worry about. Yes, there will be a valuation, there will be some smiley face and some sad face results but does a 0.5% increase, or decrease, in employer contribution rate really have the same impact as it used to, as councils manage 40% reductions in funding?

Secondly, in Kent the main adverse movements for employers are down to issues at employer level – investment returns were above the actuarial assumption and we were a top quartile performer, so no mileage in blaming the administering authority if your rate has gone up because it’s down to decisions your council has taken.

Finally, I think there is a high degree of nervousness because the government Actuary Department, sort of the FBI of the actuarial profession, is going to redo all the valuations on a consistent set of assumptions.

If I was one of those small number of actuarial firms active in this market I would not be very happy about that.

Heads up: returns for local authority funds have been favourable



“LGPS funds returned 15% during the year compared with 9% for corporate funds, due to the strong performance of equities

In fact, as a humble taxpayer I’m not very happy about it either. Independent funds have commissioned actuaries to do this work and now it’s going to be done twice. It’s almost like it was a single pension scheme.

What I am pleased to see, thanks to State Street and its WM Survey, is a highly favourable outcome for investment returns of local authority funds in 2013. Its figure for the Local Government Pension Scheme as a whole is that funds returned 15% during the year compared with 9% for corporate funds, due to the strong performance of equities.

Not only did equities perform strongly but local authority funds have much higher equity allocations on average than corporate schemes, 63% compared with 38%.

The fact corporate schemes have a lower equity weighting reflects the fact many of them are closed to new entrants and also the bizarre accounting rules which they have to meet on their pension liabilities.

So, after the concerted attacks on local authority funds in 2013 for paying investment managers too much and not

Continued overleaf



## State appraisal statutes: an underused shareholder remedy

There are many occasions when shareholders of a corporation are deprived of their ownership interest in that corporation, against their will, either through merger, recapitalisation or as the result of some other corporate transaction. Even when shareholders do not believe that the transaction involves any illegal or improper actions on the part of management or the controlling shareholder, they may still be entitled to a premium over the deal price. Such a premium may be available through the use of a statutory appraisal proceeding.

Indeed, empirical evidence from appraisal cases over the past 20 years shows awards of more than 400% above the deal price are not uncommon and that the median premium exceeds 80%. Further, by statute, interest awards are 5% above a federal funds rate for the period during which the proceeding was pending.

### Right to appraisal and applicable procedures

Section 262 of the Delaware General Corporate Law (DGCL) governs the appraisal remedy for Delaware companies and provides an appraisal right in a transaction where the shareholders receive cash in return for their shares, but not where a shareholder received shares of another corporation.<sup>1</sup> The right to pursue an appraisal is available to any stockholder of a Delaware corporation who<sup>1</sup> holds shares of stock on the

date of the making of a demand for appraisal; and<sup>2</sup> continuously holds such shares through the effective date of the merger or consolidation;<sup>3</sup> has neither voted in favour of the merger or consolidation nor consented thereto in writing; and<sup>4</sup> files a demand for appraisal with the corporation

“Appraisal litigation should be part of every investor’s process of evaluating potential cash-out transactions

prior to the shareholder meeting where the transaction is to be voted upon.<sup>2</sup> Where the above requirements under Section 262 are satisfied, the “dissenting stockholder has an absolute right to an appraisal.”<sup>3</sup>

Once an appraisal action is commenced, there is no motion to dismiss. The filing of the petition and compliance with the requirements of Section 262 establish the existence of a claim.<sup>4</sup> Because of the narrowly focused nature of the appraisal remedy, appraisal litigation is usually less time-consuming, expensive and onerous than litigation where the primary goal is to determine whether a defendant did, or did not, commit an illegal or improper act. Therefore, it is often possible for an appraisal case to be tried within 12 to 24 months after the petition for

appraisal is filed, as opposed to three to five years in other types of complex litigation.

### Fair value

The Delaware Code requires that a shareholder be paid fair value for the shares subject to appraisal.<sup>5</sup> Fair value requires that the corporation be valued as it is operating at the time of the transaction. The shareholder then receives their interest in the going concern as represented by its percentage shareholding (if it owns 10 percent of shares it gets 10 percent of the value).<sup>6</sup>

Fair value is not the market value of the shares – ie, what they would fetch on the open market. Further, the determination of fair value does not include any value that may be created as the result of the transaction that caused the appraisal, such as new management’s plans, for example. The appraisal is of the company exactly as it was being run.<sup>7</sup>

In valuing a company, there are a number of different methods that can be used including the discounted cash flow (DCF) methodology, the comparable companies methodology, and the comparable transactions methodology. Although the DCF methodology is often used by Delaware Courts, no one methodology is required and the goal is to use the methodology that best captures the going concern value of the entity being appraised.

It is important to note what an appraisal proceeding does

not involve. It does not require allegations of wrongdoing on the part of the corporation or its executives or any claim that they breached a duty or somehow acted improperly. The only issue is the value of the shareholder’s stake in the corporation.

### Conclusion

Investors should be fully aware of the possibility of an appraisal action in determining whether to vote for and ultimately accept the proceeds of any transaction in which they are being cashed-out of their investment.

In those cases where there is an allegation of self-interest in the transaction, there is a good prospect for a recovery that is in excess of the deal price. Moreover, such a recovery can be obtained more expeditiously and efficiently than other forms of litigation and without any accusation or determination of fault by the defendant company, its management or its controlling shareholders. Therefore, full awareness of the requirements and potential value of appraisal litigation should be part of every investor’s process of evaluating potential cash-out transactions.

<sup>1</sup> DGCL §§ 262(b)(1), (2).

<sup>2</sup> Id. at § 262(a).

<sup>3</sup> *Kaye v. Pantone, Inc.*, 395 A.2d 369, 375 (Del. Ch. 1978).

<sup>4</sup> Id. at 375.

<sup>5</sup> 8 Del. C. § 262.

<sup>6</sup> *Paskill Corp. v. Alcoma Corp.*, 747 A.2d 549, 553 (Del. 2000); see also *Tri-Continental Corp v. Battynne*, 74 A.2d 71 (Del. 1950) (“the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern. By value of the stockholder’s proportionate interest in the corporate enterprise is meant the true or intrinsic value of his stock which has been taken by the merger.”).

<sup>7</sup> 8 Del. C. § 262(h).



Continued from previous page

knowing what they were doing, it's good to see some independent support for how well the 89 LGPS funds are doing.

So what do the results of the valuation look like? Well in Kent, a £4bn fund with 110,000 scheme members and 430 employers, the position is mixed. At fund level the positive investment returns, lower than anticipated pay increases and higher than expected mortality (apologies for the smiley face for that) all helped to offset the impact of gilt yields being where they are and the adverse impact that has on the value of liabilities.

At fund level the funding level has improved slightly and the employer contribution rate at fund level is fractionally down.

So, at face value everyone should be fairly happy. But unfortunately (as ever) the devil here is in the detail. And telling 11 of the 12 DC chief financial officers in the county that their contribution rates were going up was painful. The one district where the rate could go down, plus a lower rate for the county, the Medway Unitary Council, Police and Fire, all just keep their heads down and breathe a sigh of relief.

So, what has really determined these significant differentials between employers in the same fund who have all had the same investment returns and actuarial assumptions applied to them? Have you been doing large-scale shared services? Have you been outsourcing significant numbers of staff?

If you have, the effect in pensions terms is that the future pensions liabilities for the staff have transferred to someone else. But what is called the past service deficit has stayed with you, and you



Face value: the position in Kent is mixed

have fewer active members, so the gearing effect, or relationship between your smaller active workforce and your proportionately bigger pension liability, has substantially increased.

This is even more painful when the actuary insists, quite rightly, that rather than pay the past service deficit as a proportion of payroll you need to pay it as a cash amount.

This is quite painful financially and could well mean you effectively lose a good proportion of the saving which you think you have made from shared services or outsourcing.

So, when councils are taking those decisions in the future they need to work very closely with their administering authority and fund actuary to take this into account in their decision making.

While I have focused here on the impact of shared service and outsourcing there is of course a more general issue for all councils, and that is the continued contraction of the workforce and falls in payroll.

Kent CC's payroll was down 15% over the period, although a substantial amount of that

was due to academies who, thankfully, take their deficits with them.

We have DCs where the payroll has fallen over 30% in that period, although figures of that magnitude include the effect of shared services and outsourcing.

Which really brings us to what happens next with another actuarial valuation, if it happens, now only slightly over two years away.

Well, over the next few months I assume the main issue will be the comparison of results and the government Actuary Department's findings. How do they question or criticise the the actuarial assumptions individual firms have made? And what will be done with the findings once actuaries have signed off contribution rates for the next three-year period?

What we can be quite clear about from the government's Autumn Statement and the Provisional Local Authority Finance Settlement is that councils' overall funding positions will get worse. A 13.6% reduction in the Settlement Funding

Assessment nationally, to be followed by a 15.7% reduction in 2015/16, is already being reflected in headlines round the country for the spending reductions councils will have to make.

So we know council payrolls will continue to contract significantly and the amount they pay in to their pension fund will become a greater share of their total budget because of the past service deficit.

For administering authorities the income they receive from employers will go down. The employer contributions into the Kent Fund, for example, are now lower than they were three years ago, and I think they will, if anything, accelerate downwards. It seems from the grapevine that the cash flow position of funds varies significantly but some are already cash flow negative and are having to sell assets to pay pensions. Kent is still cash flow positive and we have substantial dividend income, which we currently reinvest but we will need to look again at this.

Although it might be heresy to say it, I hope we do fight off investment advice to reduce equity allocations for funding as opposed to investment reasons. We really need the extra returns that equities might well bring over the next couple of years to try to close as much of the funding deficit as we can.

After that I fear we may have no alternative to reduce equity holdings, but hopefully that will be from a position of strength. This also reinforces my belief that the long-term economic viability of the LGPS lies not in playing with the number of funds but addressing the cost of the liabilities, which the LGPS 2014 reforms just have not adequately addressed.  
**Nick Vickers is head of financial services, Kent CC**

## COMMENT

BERNARD ABRAHAMSEN  
Head of sales and distribution,  
M&G Investments



# The benefits of illiquid credit

Although 2013 was another year of volatility and uncertainty – particularly after the Federal Reserve introduced the word ‘taper’ into the investment lexicon in May – it was the best year since the financial crisis for a number of asset classes. High yield and investment grade credit spreads had a great run but are now close to their tightest levels since 2007.

In today’s environment, some of our clients have been questioning whether liquidity in their fixed income investments is always adequately compensated and are therefore looking at some of the investment opportunities that sit outside traditional fixed income, such as illiquid credit.

The banking crisis in 2008 began as a liquidity crisis when wholesale funding dried up for banks such as Northern Rock. Inevitably, banking regulations are being tightened in response, which in turn is causing the market to place a high value on liquidity and liquid asset classes as demand increases. We believe that investors able to reap the liquidity premium potential of their liabilities will be able to find attractive opportunities in illiquid credit.

Today’s illiquid credit opportunities were traditionally held on banks’ balance sheets until the loans reached maturity, and so little or no secondary market developed in these areas.

However, since the financial crisis, changes in the banks’ lending behaviour

mean that institutional investors can step in and invest in these assets. Banks’ changing behaviour is driven by new regulations and an increase in the banks’ own cost of borrowing.

### How to invest in illiquid credit

Illiquid asset classes, such as direct loans, commercial mortgages, distressed debt and asset-backed securities, can increasingly provide attractive risks and returns for institutional investors. When investing in them, it’s particularly important that investors fully understand what they are investing in from the off, because it is unlikely that they’d be able to sell it if the credit quality deteriorates. But equally, discipline, patience and flexibility are important.

Many of the best investment opportunities today were not available to non-bank investors three years ago and are often still developing asset classes. In order to best access these, an investor’s parameters should be wide enough to allow a manager not to be a forced buyer as forced buying locks in poor value over the life of the asset. In this article, I will highlight one example in particular.

Banks have dominated lending to companies across Europe for a generation but this has been changing in recent years with increasing numbers of large companies accessing the public corporate bond market for financing and new non-bank lenders

making medium to long-term loans directly to medium sized businesses.

We have made more than £1bn of these bank-replacement loans on behalf of institutional investors including our parent company, pension funds and HM Treasury. Investors in the sector are attracted by the steady floating rate cash flows delivered by the loans over their five to 10 year terms.

Because the companies concerned don’t usually issue

from an illiquidity and/or complexity premium. The fund targets return of Libor +5-6%.

Another benefit of this approach is that, alongside the asset classes mentioned, the portfolio can also invest in one-off illiquid opportunities that are insufficiently available for a standalone fund but have very attractive characteristics. For example, corporate leasing is an area we are investigating as a potential new source of

“With all of the skills in place, there are a range of interesting opportunities for institutional investors to tap into

bonds in the public debt market, investors also gain diversification away from traditional corporate bond benchmarks.

### Bringing illiquid opportunities together

Each illiquid credit sector can offer compelling opportunities for investors but availability and relative value between asset classes can change quickly as new buyers enter a market. By bringing together a fund targeting a range of illiquid opportunities, investors can access the diversified risk and returns of a range of asset classes and can ensure that when certain asset classes become too expensive to offer good relative value they do not become a forced buyer. The M&G Illiquid Credit Opportunities Fund seeks to source assets which benefit

attractive adjusted returns giving our clients a further premium for being early participants in a market.

As ever, investing in assets such as these requires a great deal of expertise. Investors need to be well-resourced, with dedicated credit analysts, legal specialists, restructuring analysts, deal originators and experience in structuring and analysing private debt. With all of the skills in place, there are a range of interesting opportunities for institutional investors to tap into.

To finish where we began, the world has changed, and for several reasons we believe that the banking system cannot return to its old ways of doing business. Institutional investors can take advantage of this shift to finance illiquid assets and receive attractive risk-adjusted returns for doing so.

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# Where next for LGPS investment

**CLIFFORD SIMS** considers how the Department for Communities & Local Government may address the question of reform and take the call for evidence on the future structure of the LGPS going forward



Last year was a landmark one in the history of public sector pensions, with the enactment of the Public Service Pensions Act. As LGC readers will be aware, the PSPA changes the benefit structure to career average under the Local Government Pension Scheme, with effect from 1 April 2014 (with governance changes due to come into force one year later).

Now that the shape of the benefits is fixed (subject to some final transitional regulations being put in place), the practical job of making sure benefits administration works smoothly will be one of the key priorities for officers of administering authorities. Another pressing priority is to finalise the 2013 actuarial valuations, with the consequential changes to rates and adjustment certificates for scheme employers.

With such priorities, it is

## CALL FOR EVIDENCE

- To reduce investment fees
- To improve the flexibility of investment strategies
- Provide for greater investment in infrastructure
- To improve the cost effectiveness of administration
- To provide access to higher quality staffing resources
- To provide more in-house investment resource

understandable that the debate, which has been rumbling for several years, over the future of the investment regulations governing LGPS funds has been put on the proverbial backburner. Central government has, of course, had the same problem in terms of prioritising its resources and attention (magnified by the little matter of having to deal with other funded and unfunded public sector schemes).

However, local government minister Brandon Lewis has made it clear to LGPS funds that he has not overlooked the possibility of structural reform of the LGPS with two high-level objectives: how to deal with deficits; and how to improve investment returns. These objectives, together with six further secondary objectives were set out in the Department for Communities & Local Government's Call for Evidence on the future structure of the LGPS, which was published in June 2013 (see box).

The Call for Evidence solicited 130 responses by the end of September 2013 and the LGPS sector has eagerly awaited the government's formal response.

One of the reasons why no response or further consultation paper has been forthcoming is that DCLG (together with the Cabinet Office) decided to commission separate advice in October 2013 on three specific investment-driven models which emerged from

Cutting through the red tape: making sure benefits administration works smoothly will be one of the key priorities for administering authorities



some of the submissions to the call for evidence. That advice, which was provided by Hymans Robertson LLP, together with my firm, Squire Sanders (UK) LLP, and CEM Benchmarking, remains confidential to government, but the questions asked give some indication as to how DCLG may address the question of reform and take the call for evidence going forward.

## DCLG's three options

Government asked for an assessment of both the investment and legal issues raised by and obstacles to

three separate options:

1. a single asset pool covering all 89 administering authorities in England and Wales where assets would be held under one collective investment vehicle, but decision making on asset allocation and contribution strategies would remain with the current administering authorities;
2. five to 10 new asset pools again structured on a collective basis, but where the administering authorities would, as with option one, retain responsibility for decision

# Investment regulations?



making on asset allocation and contributions; and

3. five to 10 fully merged funds, where responsibility for liabilities as well as assets (and therefore deficit management etc) would pass to new bodies.

All of these models would require legislative intervention to take away the powers of investment, which are currently given to specific administering authorities, in order for those to be redistributed to new bodies. The political sensitivities of following such a path to reform are obvious; government will also be

acutely aware of the local elections in May and, of course, the timing of the next general election, which must take place at the latest by May 2015, if any primary legislation is deemed necessary for wider restructuring.

In this context, what can we expect in terms of investment regulatory reform?

The first option for DCLG is to do nothing. If there are no obvious cost savings to be derived from changing the current regulatory regime and it can be demonstrated to be delivering optimum investment returns, then the status quo may be attractive, especially with all of the other more pressing benefit and governance issues which need Parliamentary time.

But that begs the question of whether the investment regulations do deliver the best possible outcome. This is partly a question of the efficiency of the governance arrangements for managing LGPS funds (which are not set out in any detail in the investment regulations) and partly whether the current asset allocation limits, which are set out in Schedule 1, inhibit optimum investment choices. Those limits do not restrict pooling of investment by LGPS funds either amongst themselves or with other investors, but they do place concentration limits for an LGPS fund on the use of certain types of collective investment vehicles managed by the same body (35% for unit trusts, open-ended

investment companies and life companies and a separate limit of 30% on interests in partnerships).

The problem with the Schedule 1 limits is they represent a fairly crude method of approaching the principle of diversification of investment risk. It is perfectly possible to comply with the limits without real diversification of investment risk, since an LGPS fund could be invested 100% in listed equities, but only subject to a separate single holding limit of 10% in any one stock.

A more fundamental problem with the limits is that, because they refer specifically to the legal structures or wrappers which are used by investment providers, they focus on the form rather than the substance of the underlying investment.

Finally, there is the related problem that, as with any legislation, it can easily become out of date. The investment regulations do not

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for instance deal with a number of widely used overseas collective investment vehicles (such as those common in Luxembourg or Ireland) and nor do they refer to the new tax efficient collective vehicle, the Authorised Contractual Scheme, which the UK government introduced in July 2013 to rival similar Luxembourg and Irish tax transparent pooling vehicles.

The Authorised Contractual Scheme has excited interest among London councils, which are well under way with a project to examine the feasibility of establishing such an arrangement to pool assets in a way not envisaged by the investment regulations.

## Conclusions

It would be foolhardy to prejudice DCLG's next step as far as the wider question of structural reform is concerned. One obvious and fairly easy win, however, would be to move away from the current rigidity imposed by the investment regulations and drop the limits that currently apply to some but not all forms of investment. This could be done by using secondary legislation and using a prudential framework which applies to private sector schemes, where the focus is on high level principles not asset allocation. The bigger question of who should ultimately exercise those powers of investment would of course remain open for debate. Clifford Sims is a partner at law firm Squire Sanders



# The pieces of the LGPS governance

PAUL KENT attempts to piece together the 2015 Local Government Pension Scheme governance structure puzzle



There's a bit of a knack to jigsaw puzzles. Usually it is a good idea to find the corner pieces first, then the edges to see the size of the puzzle and then start filling it in, preferably by reference to the picture on the box lid. Some people (like me) like to set themselves a bigger challenge by trying to do the puzzle without looking at the picture.

So what does the 'puzzle' of the 2015 LGPS governance structure look like and how should it all fit together? Are we looking at a joined-up high definition picture where all the pieces fit together easily? Or is it a bit of a patchwork quilt? Or, indeed, have we got a puzzle in front of us with no picture on the box at all?

## The Public Service Pensions Act 2013

The first part of the puzzle is the Public Service Pension Act 2013. Under the act there are four seemingly 'new' pieces under the section on governance – the responsible authority, the scheme manager, the Scheme Advisory Board and the local pensions board.

The responsible authority is, of course, the secretary of state for communities and local government, who remains responsible for the LGPS in England and Wales as well as the Fire Pension Scheme in England. Nothing new there.

The scheme manager is defined in the LGPS Regulations 2013 as the existing administering authorities in England and

Wales. So, nothing new there either.

The Scheme Advisory Board is new, however. This is a national board (currently in 'shadow' form), set up to provide advice to the responsible authority on request, but also to advise local pension boards and scheme managers as deemed appropriate.

Pension boards are also new. Scheme managers are required by regulation to establish a pension board, whose purpose is to assist the scheme manager to ensure compliance with scheme regulations and other legislation as well as to ensure compliance with The Pensions Regulator's codes of practice.

To stick with the analogy of a puzzle, what is clear, at least to me, is all these pieces are different colours and sizes,

meaning that, evidently, this puzzle must have a lot more pieces to it. My early attempts to try and fit these together failed, and in any case when I looked in our pensions 'box' I discovered there were a lot more pieces in there.

## Other governance structures

Some of these I recognised from previous puzzles. For example, the pension fund committee (set up under S101 of the Local Government Act 1972), the fund administrator, the Myners Principles (quite a lot of pieces here), the governance policy and compliance statement and the pension fund annual report.

The latter, of course, includes publication of the funding strategy statement, the statement of investment principles, a voting issues policy, a training policy, a

communications policy and compliance with the CIPFA Knowledge and Skills Framework and the UK Stewardship Code.

In addition, the fund actuary and the administering authority's S151 officer and monitoring officer play a key role in ensuring that pension fund committees operate efficiently and within the law. And of course, internal and external auditors regularly test arrangements for accounting, value for money and internal control.

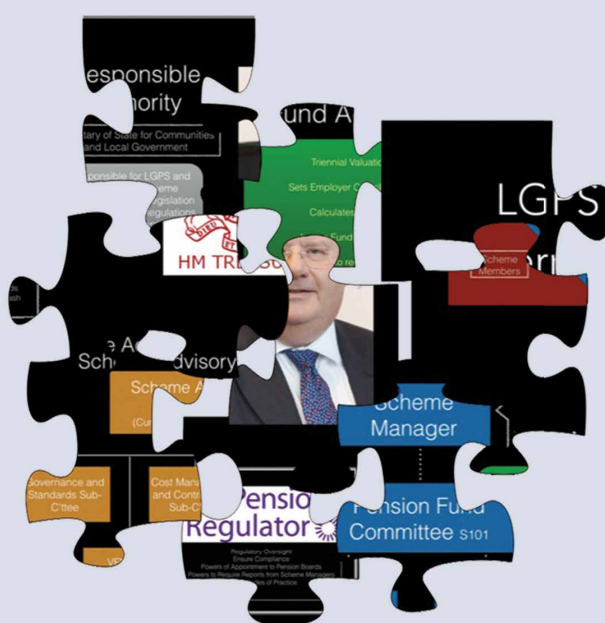
I felt most of these pieces had straight edges, so I was finally beginning to get a good impression of the size of the puzzle.

There were also a few new pieces in the box that were not in the picture before, most notably The Pensions Regulator and HM Treasury – oh, and a rather odd-shaped piece from the Cabinet Office. I'm not sure where this one fits in.

The Pensions Regulator is charged with oversight of all pension schemes, public and private, and issues codes of practice with which all schemes must comply. Also, should pensions boards fail to exercise their responsibilities effectively, The Pensions Regulator has the power to appoint persons to the board to ensure those responsibilities are properly discharged.

The Treasury has extensive powers of direction over valuations, including data, methodology and assumptions.

HM Treasury also sets the



# Finance jigsaw

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employer cost cap and has powers to change schemes to ensure that the cost remains within approved margins.

This is where the work of the Scheme Advisory Board is so important, in advising the responsible authority, in order to obviate the need for HM Treasury to exercise their powers.

When I looked at the pieces that were left, some seemed to fit nicely in the responsible authority corner, and a number of pieces around independent advisers, local democracy and the fiduciary responsibility went with the scheme manager.

Interestingly, the scheme manager has gained some new regulatory responsibilities including:

- A duty to report late payment of contributions by employers to The Pensions Regulator
- A duty to establish and operate internal controls to ensure the scheme is administered and managed in accordance with scheme rules and the law (but we do this now anyway)

#### Advice and scrutiny

There were also some very specific pieces of our puzzle with odd names, such as the cost management and contributions subcommittee, the investment and engagement subcommittee,

the governance and standards subcommittee, the administration and communications subcommittee and the value for money and collaboration subcommittee, which all seemed to fit nicely under the Scheme Advisory Board.

The most difficult section of the puzzle was the section on the local pension board. Half the pieces were, to my mind, one colour and half another, and they didn't seem to fit with each other, never mind the rest of the puzzle – and I couldn't find enough of them to complete the picture.

Some pieces seemed almost to fit with the scheme manager section, but only if you forced them. Eventually, after a lot of head-scratching it seemed that these formed a new section called 'scrutiny'.

Anyway, I think I have done it. If you want to try it yourself, copy the following link into your browser: <http://app.upinpieces.com/puzzle/links.php?i=52e546afa5efe>

Finally, as I thought, there is no place in our puzzle for the Cabinet Office. Perhaps it belongs with a different puzzle – the 'Restructuring of the LGPS' perhaps, which potentially could throw all the above pieces into the air. **Paul Kent is chief financial officer and fund administrator for the Dorset CC Pension Fund**

## COMMENT

JAMES SPARSHOTT  
Client relationship manager, Legal & General Investment Management



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