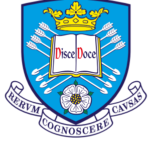

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The rationale for local authority pension fund investment decisions.

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This Brief assesses the rationale behind the strategic asset allocation of the UK's largest local authority pension funds (LAPF) since the 2007/2008 financial crisis. The analysis builds directly upon that of our previous Brief, *Local Authority Pension Fund Investment Since the Financial Crisis*, which charted changes in the investment patterns of pension funds between 2005 and 2016. This Brief explores the basis of these changes, such as the move away from equity investment, and the partial move towards 'alternative' investments such as infrastructure. It also explores LAPF attitudes towards further 'pooling'; that is, the agenda, first developed by the Cameron government, to merge LAPFs into a small number of 'mega-funds'.

Background

Wider context

- Local authority pension funds hold assets worth more than £200 billion. The largest of these funds are among the largest institutional investors in the UK.

- Whereas private sector funds are generally being replaced by individualised defined contribution schemes, local authorities remain committed to the collectivised defined benefit model.

- However, local authority funds are experiencing some of the same problems as those in the private sector, with demographic change increasing liabilities, a difficult environment for investment returns and declining active memberships due to the impact of severe impact of cuts in public expenditure on recruitment within the local government sector.

- Local authority pension funds have also been impacted by the consequence of pay restraint on employee pension contribution. The introduction of automatic enrolment in workplace pension schemes and abolition of 'contracting out' from National Insurance contributions have similarly proved costly for local government pension scheme (LGPS) employers.

Quantitative research

- Our *previous Brief* summarised the key post-crisis trends in LAPF investments. LAPFs to some extent mirror private sector defined benefit funds in having moved away from equity investments.

- However, this shift relates solely to UK equities. The 25 largest LAPFs halved their allocation to UK equities to 18 per cent from 2005 to 2016, while their allocation to overseas equities increased from 27 to 35 per cent.

- Furthermore, LAPFs have not followed private funds in moving instead into bond investments. The average allocation by the 25 largest funds only increased from 13 to 16 per cent from 2005 to 2016.

- Interestingly, the 25 largest LAPFs' allocation to 'alternative' investments over this period has not increased significantly. However, they have quadrupled their allocation to infrastructure investments (albeit from a very low base; 1 per cent in 2005, rising to 4 per cent in 2016).

- The largest LAPFs are far more willing than private funds to invest directly in property, although their average allocation to property has decreased in recent years. There are, however, significant issues regarding the reporting and categorisation of investments in 'unconventional' assets such as property, infrastructure and private equity.

Pooling

- This Brief also considers the issue of 'pooling'. As Chancellor of the Exchequer, George Osborne advanced proposals for the merger of all local authority funds into a small number of 'mega-funds', designed to enhance funds' capacities to invest in long-term assets such as physical infrastructure.
- To date, proposals have been submitted by all 89 LAPFs to form a series of 8 of these so-called mega or 'pooled funds' with combined assets of more than £200bn.

Evidence

- This section accounts for the rationale behind changes in the asset allocation of the largest 25 LAPFs between 2005 and 2016, based primarily upon a qualitative analysis of annual fund reports (available from http://lgpsboard.org/). It considers strategic allocation trends in relation to four asset classes; equities, bonds, alternative investments and property.
- It also presents evidence on the attitudes of the largest LAPFs to the pooling initiative, to which all have contributed, as documented in annual reports and supplementary material.

Equities

- The rationale behind the changes within equity allocations is relatively simple to articulate. The shift towards overseas equities can be explained by the strong performance of global equity markets.
- Strong economic indicators emanating from Europe, the US and Japan have been cited by funds as a key driver in the decision to increase allocations towards overseas stock over the period in question.
- Specifically, significant cash returns generated by overseas equities holdings have underpinned the rationale of certain funds' preference towards increasing overseas equities allocations.
- Additionally, macro-economic stimulus measures, along with the actions taken by various overseas central banks from 2013 onwards, particularly in the US and Japan, have led many LAPFs to conclude that equity investment risk within these markets has been significantly mitigated (in contrast, implicitly, to the UK).
- While the US, Japan and emerging markets have remained a favourable destination for LAPF investment, interest in European equity markets has been resurgent in recent years, with several large funds increasing their weighting towards European equities from around 2015 onwards.

- The rationale behind this shift appears to be underpinned by a general consensus that while European equity markets have presented a challenging investment environment since the financial crisis, concerns over Greek solvency had distracted investors from a number of positive economic developments, such as attractive valuations and dividend offers.

Bonds

- LAPFs have not charged into bond investments to the same extent as private sector defined benefit funds since the financial crisis.

- However, the challenging economic environment means that bonds – despite low yields across most bond markets – continue to be favoured by LAPF fund managers due to their steady returns and perceived safe haven' status.

- Within this broad picture, however, three key contributing trends are revealed by LAPF annual reports. Firstly, the prospect of protracted low yields in core bond markets, located in the UK, US and Europe, has led fund managers to begin to partially switch attention to emerging market bonds, denominated in local currencies.

- Secondly, with nominal bond yields sinking, many funds, from around 2013 onwards, opted to back their pension investments with longer-term, index-linked gilts as a means as part of a de-risking strategy (even if this meant negative yields in real terms).

- This was also accompanied, again from around 2013 onwards, by a sell-off of UK government bonds, with proceeds subsequently being reinvested in corporate bonds. This increased exposure to corporate bonds was predominantly executed on a 'buy and hold' strategy, with bonds being held to maturity in order to mitigate risk.

Alternative Investments

- A range of 'alternative' investments are discussed in fund reports. It should be noted, again, that there is a lack of uniformity around whether assets such as infrastructure are an asset class in their own right, or instead reported in generic alternative or 'other' categories.

- Infrastructure investments have grown in popularity among fund managers as they tend to offer stable, long-term returns, as well as providing an important source of diversification.

- Investment exposure has in the past been gained by holding investment trusts or unit trusts, which provide equity or debt capital for infrastructure activity, typically providing yields of around 5-8 per cent.

- However, while LAPFs continue to invest in traditional infrastructure funds, following the financial crisis, we have seen a number of funds switch to more direct infrastructure investments, particularly within the renewable energy sector, both in the UK and overseas.

- The ability to invest directly minimises fee costs, and has enabled funds to negotiate favourable investment terms. As such, many funds are reporting, or are projecting, a significant rate of return, resulting in an increased appetite for such investments.

- Among alternative assets, however, LAPFs remain far more likely to invest in private equity than infrastructure (although the two are not mutually exclusive). LAPFs are attracted to the possibility of direct access to firms not publicly traded on a stock exchange, or at an earlier stage of growth, thereby offering the prospect of better returns at a time when traditional equities and bonds have delivered below expected gains.

- A consensus that the private equity industry, with attractively priced opportunities, will provide funds with above-average returns is clearly evident amongst the largest LAPF funds.

- Indeed, funds are forecasting a period of strong activity in this area. Improved valuations, reflecting improving trading conditions for portfolio companies and upgraded quoted market values, has led many of the largest funds to conclude that private equity portfolios are well-positioned to take advantage of any sustained growth in the global economy.

- However, funds do recognise the higher risk profile and lack of liquidity in these investments, which may explain why exposure remains restrained.

Property

- LAPFs have favoured the UK commercial property investment market since the financial crisis – property is perhaps the main investment type where the UK has remained as attractive to institutional investors. The recent weakness of sterling has, however, contributed to this trend insofar as it problematises direct overseas investment in property.

- Property in London and the South East, particularly office space, continues to outperform other parts of the property sector, and has been favoured by LAPFs for this reason.

- Accordingly, LAPFs acknowledge that returns offered by commercial property (in the form of rents) outside of London and the South East have been constrained, and are likely to remain so. As a result, several LAPFs have begun to restructure their property portfolios, targeting exposure to the growing trend towards trade parks and regional logistic units over high-density office space, in most parts of the country.

- Despite this, property investments continue to form an important portion of funds' investment portfolios because of both the diversification benefits that real estate investments bring and the rental income generated that is used to fund member benefits without the need to liquidate other investments.

Pooling

- The LAPF pooling agenda initiated by the Cameron government in 2015 was intended to both deliver administrative savings, and to make large-scale infrastructure investment – railway, road and other transport facilities, and the housing supply – more accessible to local authority pension funds.

- At the summer Budget 2015, the Chancellor George Osborne announced proposals for the pooling of Local Government Pension Scheme (LGPS) investments.

- Each LGPS administering authority would be obliged to join, or help create, an investment pool with other LGPS administering authorities (many authorities are of course already the result of mergers of LAPFs within city-regions).

- There is a degree of scepticism about the government's plan among the largest LAPFs. While they generally recognise that the pooling initiative will amount to significant savings in the long term, it is estimated that it could take more than ten years to achieve these predicted savings, with the cost of implementation likely to exceed savings in the short-term.

- LAPFs expect that gains would be tempered by costly exit fees or other penalties associated with illiquid assets.

- The transition of assets on the scale needed to meet pooling requirements has never been attempted before. As such, LAPFs have stressed that the risks and associated costs of pooling should not be underestimated, particularly in the context of continuing budgetary pressures and severe internal resource constraints within local authorities.

- Local authority funds have also expressed concerns that *The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (SI 2016/946)* may provide the Secretary of State with powers which are incommensurate with how funds are administered. For example, the *Explanatory Memorandum (para 7.10)* states that Regulation 8 'provides the Secretary of State with the power to intervene in the investment function of an administering authority if he is satisfied that the authority is failing to act in accordance with the regulations and guidance'.

- It has been suggested that such broad powers over pooled funds could mean that it is the government that decides what funds invest in, with limited regard to the impact to the payment of member benefits and the costs to employers and members. Returns from local or regional investment in infrastructure, for instance, have traditionally been less certain than other asset classes. LAPFs have expressed concerns that by compelling pooled funds to invest in infrastructure, the pooling initiative could compromise returns and subsequently members' benefits.

Analysis and Conclusions

The analysis in this Brief confirms our earlier analysis that, compared to private sector defined benefit funds, the largest LAPFs have since the financial crisis not been as conservative in making decisions around asset allocations. However, it is clear that they remain rather conventional in their investment decision-making, with a growing interest in alternative investments a product of the need to hedge risk through diversification, just as much as it is a product of a greater appetite for riskier, but potentially transformative, investments.

Pressure to meet short-term liabilities without jeopardising the long-term profile of funds, coupled with market and economic turbulence, continue to shape the strategic orientation of LAPF investment decision. Asset classes with a proven track record of delivering stable and steady income streams, such as equities and bonds, generally continue to be favoured over alternatives such as infrastructure, which may be subject to greater fluctuations or political sensitivity.

The prospect of localising investment strategies among LAPFs seems as distant as ever. They have less faith now in the UK's economic prospects than before the crisis – the partial exception is property investment, but allocations are concentrated in this area in commercial property in London and the South East. They are sceptical of the benefits of further pooling, and indeed resistant to politically-driven efforts to induce LAPFs to invest in local infrastructure projects.

This is not intended as criticism of LAPFs. The demographic and investment environment for LAPFs is extremely challenging, in part as a direct result of recent governments' rather disastrous record in managing the economy, public finances and public services. Stakeholders and policy-makers need to give proper consideration to the underlying rationale for the conventional investment path invariably chosen by LAPFs, including their primary duty to scheme members.

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