Local responsibility

With new codes and principles being established to ensure that pension schemes are declaring their investment strategies, Jack Gray speaks to LPP deputy chief investment officer, Richard Tomlinson, about how Local Government Pension Scheme (LGPS) and public-sector scheme investment strategies differ from the norm

What kind of investment strategies are you seeing in the LGPS space?
There's a lot of debate on the active/passive divide. When I see a comment on the active versus passive debate, a lot of it seems to just say active managers haven't beaten the benchmark and therefore they haven't done very well. That may or may not be true, but that's quite a retail way of looking at the world. When I say retail, I mean private wealth, where you can pretty much do what you want with your own money. It then comes down to your own ethical preferences.

But in the institutional world – and it's getting more and more the case – you can't simply just buy whatever assets you want. You have ESG considerations. You have reputational risk issues. You have other constraints placed upon you.

Once you start layering in these additional constraints, the simplistic 'just buy global equities' isn't quite so simple anymore. This concept that there is just this market and you can hoover up doesn't quite fit anymore for many institutions.

The aim is building portfolios that are optimally positioned based on a scheme's investment beliefs, their constraints and being very cost efficient. If you can get the cost low enough in an active portfolio, the level of the risk exposure that you want in an ESG framework that makes sense to you and, critically, with low turnover. If the costs are low enough, that to me is a much better place to be than simply buying up passive equities.

On the passive equities argument, the minute you start deviating from a pure market cap benchmark, you're making an active investment decision. Even in buying a market cap weighted benchmark, you're making an active investment decision. Because, there are residual momentum components in there. If you think about it, which stocks have the highest market cap today? It's the stocks that have performed well in the last quarter or last momentum.

How about alternatives?
On the alternative side, or actually across the whole portfolio, it is very much looking at the split of return or excess return – or what I would call 'alpha' – split between the investor and the manager. If the manager's fee structure allows you to take an appropriate split of that value add, well, that's more acceptable. If the manager's fees are too high, whatever the value add or alpha is, then it doesn't make sense.

Even if a manager is adding huge amounts of value, if the fees are too high, there's not enough left once you adjust the risk for them or for the investor. Well, why would you do it? I find it hard to see how an average manager can deliver sufficient excess return for an investor net of the fees they're charging.

How does the long-term strategy differ for LGPS schemes?
With your average corporate pension scheme, most of them are in some kind of endgame or looking for some kind of endgame. If you think about the driver for a corporate DB, it's to provide the benefits and knock out the liabilities and minimise the earnings volatility of the corporate sponsor. So, your CFO or your CEO is saying 'I want to immunise my exposure to these liabilities'. Whereas the LGPS is a little different, because it's open to new members and accrual. It's a quasi-perpetual investor.

Then you layer in the fact that you're part of the fabric of society, because you're ultimately backstopped by the state and the taxpayer. You're not just this lone

private-sector operator, you are needing to think more holistically about your role.

I certainly think deeply about this, in terms of what to do with an investment portfolio. In terms of what you may call ESG – so whether it's climate change, whether it's housing, whether it's contributing to the local economy or whatever it'll be. You also have to consider LGPS schemes' roles in terms of capital markets, because I think large institutional investors have a responsibility to play in terms of the functioning of markets and the economy.

If you start thinking about what the role is in society in terms of the capital markets, you start thinking, 'as long-dated institutional investors, we have long-dated liabilities'. The liabilities often extend beyond 20 years. Long-dated institutional investors are able to buy assets and hold them for the long term, whereas some other investors can't. If assets are out of favour currently and are being sold down, whether they be equities or credit or property or whatever it'll be, they can be legitimately bought and held on to for the long term.

Long-dated investors are going to buy them because they think they have a long-term payoff for their fiduciary responsibility, which is the primary driver. But there is also this piece, which is 'what is the role of long-dated capital in the functioning of the economy and the capital markets'?

I do have a philosophical aversion in some ways to this spew that you hear some people putting forward that pension schemes should just be the dumb money and to just buy equity indices and should just buy passive investments, because pension funds are stupid and should leave the risk taking to those that should be doing it, like hedge funds. I would say the exact opposite that if you think about who should be able to take the long-term view, who should be able to invest for the long term in stable businesses, who should be able to provide the right sort of capital for genuinely strong, good companies or enterprises, shouldn't it be pension schemes?

The time horizon of most active trading books is much shorter. The asset management industry, people always joke that it gets shorter and shorter. You're now on a quarterly performance target for many asset managers. If people like us can't take that long-term perspective and invest in business because we think they've got long-term prospects, well, who can?

What are the typical questions you receive from LGPS members?

You tend to find that member questions broadly fall into two camps. One is very administration focused. 'Can I get my statement online? Can you make it easier for me to access this piece of information or that information? Can you make the wait time on the calls two minutes less?' Or that type of transactional query.

But from the investment side, the queries tend to focus on ESG/responsible investment type queries, climate change. You'll get very direct questions on 'what is the scheme's policy on this element of climate change? What are you doing for members on – are you thinking about this risk factor from that area? What are you doing on fossil fuels?' Those types of things come in from members.

Are there any lessons we can learn from other nations' investment practices?

Certainly one model that we can point to is the Maple model, the Canadian model. So looking at what the Canadians have achieved in the past 30 years with their pension structures and how they've approached things and looking at some of the tenets of success. What drove success for them? Professionalisation, increased levels of delegation, getting the right people in the businesses, strong governance and sensible investment beliefs.

Written by Jack Gray