

## **OXFORDSHIRE LOCAL PENSION BOARD – 26 OCTOBER 2018**

### **MONITORING INVESTMENT EXPENDITURE**

#### **Report by the Director of Finance**

##### **Introduction**

1. This report has been provided to the Board at the request of one of its Members at the July meeting. The request was based on the requirement in the Board's Constitution for the Board to monitor investment expenditure as part of its overall duties. Specifically, the request was to present the transparency templates provided by the Fund Managers to the Board on a regular basis.
2. The report builds on the discussion at the July Board meeting, setting out the detail included in the transparency template, and prompts discussion as to how the Board should best interpret the data and in what context the data should be provided.

##### **Transparency Template**

3. The Scheme Advisory Board has developed a voluntary Transparency Code which Investment Fund Managers have been invited to sign up to. A copy of the template is attached at the annex to this report. The template has been designed to suit the management of listed assets, but the principles will be equally applicable to the alternative asset classes, and work is on-going to make appropriate amendments to the template to ensure it is fit for purposes for these asset classes.
4. The work led by the Scheme Advisory Board has been welcomed by the Financial Conduct Authority (FCA) and they are working with the Investment Association to develop a template which can be used across the industry, largely based on the LGPS template. The Scheme Advisory Board has stated that once the FCA have finalised their template, they will seek to transition from the LGPS specific template across to the new standard.
5. The Transparency Template has also been welcomed by CIPFA (the Chartered Institute of Public Finance and Accountancy) who are looking to incorporate the transparency principles into their guidance for the preparation of annual reports and accounts.
6. As can be seen from the Annex, the template requires Fund Managers to provide greater detail on the full range of costs associated with their management of the assets under their responsibility. These include the direct management fees charged by the Fund Manager, as well as the direct and indirect costs associated with the day to day transactions, any costs of

research, costs and income associated with stock lending and any ancillary costs.

7. The majority of Fund Managers providing services to LGPS clients have now signed up to the Advisory Board's Transparency Code. However, as a result of the timing of the decisions as to when to sign up, only two of the Oxfordshire Fund Managers completed the transparency template for 2017/18, being Legal and General and Baillie Gifford.

### **Issues to be Considered**

8. There has been much discussion about the monitoring of investment management costs in recent years, which has led to the work on the transparency code. A key element of this discussion is the danger that an over-emphasis on investment costs can remove the focus from the responsibility of the Scheme Manager to deliver investment returns in line with their investment strategies, so ensuring there are sufficient resources to meet the costs of pensions as they fall due, whilst maintaining as near stable employer contribution rates as possible. The Oxfordshire Pension Fund Committee whilst it receives information on total investment management costs as part of the reports on budget management, and within the annual report and accounts, does not undertake any specific work focussed on costs alone. Instead it seeks to monitor the net investment performance of each of its fund managers, following up concerns on overall performance rather than a limited review of a single aspect.
9. The information on investment management costs makes it clear that the lowest costs are payable in respect of passive listed assets, with higher costs charged by active managers and the highest costs associated with the alternative asset classes. The additional costs are associated with higher targeted levels of investment performance, and access to a greater diversification of investment risk. Any monitoring of costs must therefore be seen in the context of investment performance. The transparency template does ask for information on investment returns. As with all reviews associated with investment performance, it is important to review the information over a suitable time period to allow for the normal fluctuations in market cycles and to enable any analysis to reflect on the long-term figures. The Pension Fund's Independent Financial Adviser has stated to the Pension Fund Committee that in his opinion, 3 years is the minimum period over which investment performance should be viewed. It therefore follows that when looking at the costs of delivering that investment performance, a minimum period of three years should be considered.
10. At that point, it is valid to be asking the question whether that level of investment performance can be delivered at a lower cost, for the same level of risk and diversification, or indeed whether the Fund is prepared to accept a lower or higher cost to improve risk and/or diversification further, or target a different level of investment performance. These questions would normally be asked as part of the review of the strategic asset allocation undertaken following the conclusion of the tri-ennial Fund valuation.

11. In terms of the management fees paid to the Fund Managers, costs tend to be linked directly to assets under management (either on a fixed fee expressed at a cost per £ under management, or a tiered arrangement where the cost per £ under management reduces once certain thresholds are reached, reflecting the fixed nature of some of the costs incurred by the Fund Manager) or performance related fees which increase in line with investment performance. These arrangements will normally be fixed as part of the procurement process and contained in the investment management agreements held with the Fund Managers. Variations in these fees will therefore simply reflect changes in the assets under management and/or performance in line with the contract. There is therefore little to be gained in monitoring these costs on a regular basis.
  
12. Transaction costs will depend to a large extent on the fund managers style, the asset class and the markets they operate in. Some fund managers will seek to deliver their target investment performance by buying and holding stocks over a long period of time. As turnover in their portfolio is low, they will have low corresponding transaction costs. Other fund managers will seek to trade on a more regular basis, taking advantage of inefficiencies in the markets and buying under-valued stocks and selling them again once they reach fair value. Such managers would therefore have higher transaction costs, but could still be delivering the same level of net investment performance. Fund managers operating in home markets will have lower transaction costs where they do not have to get involved in the costs associated with currency hedging or foreign exchange. Costs will also vary between asset classes where the implicit costs which measure the spread of prices between those paid in respect of an individual transaction and the mid-market price can differ significantly. Any review of costs therefore needs to be clear on what cost variations have occurred as a result of the Fund's asset allocation and choice of manager styles, and what reflects on the efficiency of the fund managers appointed. The Oxfordshire Pension Fund Committee do monitor whether fund managers are acting in accordance with the style for which they were appointed, but this is achieved by reviewing the actual turnover figures etc. within the portfolios, rather than seeking to identify issues implied by a variation in costs.
  
13. If the Pension Board wish to monitor investment management costs through an analysis of the cost transparency templates, they therefore need to be clear on how they are going to interpret the cost figures, and what further information they need to see to provide the context for this analysis. They also need to be clear about what actions are open to them once they have completed their analysis. As noted above, a major element of the total costs is the management fee paid in accordance with the investment management agreement entered into with the Fund Manager following a tender exercise. There is therefore limited opportunity to seek a change in these costs without running a new procurement exercise. Going forward, the responsibility of replacing individual Fund Managers will lie with the Brunel company.

- 14. The Board is invited to consider the information contained in the cost transparency template, and the further contextual information contained in this report, and determine its approach to monitoring investment management costs going forward.**

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