LGC Investment Seminar Speech for Sir Merrick Cockell

Strategic Asset Allocation – Style over Substance

Thursday 26 February 2015 – 14:00-15:00

Good afternoon.

In a speech to the Gov Today November Conference last year, I outlined LPFA's views on how the LGPS could be reformed.

I made it clear that in order to solve the under-funding that is the blight of many public sector pension funds, LGPS Funds need to stop relying on safe assets and invest more widely and with more regard for the long-term. For example, in vital large-scale infrastructure projects, such as transport. Or in much needed housing stock.

We must also consider a wide range of assets: Private Equity, or a strategy we call 'buy and hold' which takes a long-term approach to investing in large corporate stocks.

Large infrastructure investments can produce yields of 7 or 8 per cent, compared to the average 2 or 3 per cent returns often achieved by investment in bonds or gilts.

Investing in bonds or gilts might ‘feel safe’, but it is often a safe way to watch deficits increase. With deficits as they are, in so many funds, we cannot invest in asset classes that produce a return lower, or only just in line with the inflation rate.

We need to learn from those pension funds that are leading the way in infrastructure investing.

Take Canada’s largest public pension funds for example. They manage around C$740bn between them.

Their investment strategy is geared heavily towards infrastructure and property, as opposed to publicly traded stocks and bonds.

They also act as ‘co-sponsors’ on bigger transactions with leading private equity firms. This allows them to have more control over their investment and to save on fees.

They are not just investing in projects, but making them happen.

This is something that UK funds should also have the opportunity to do.

The UK Government has made it clear that infrastructure investment is required and is a key driver of economic growth.

The Government's National Infrastructure Plan includes about £375bn of investment potential in energy, transport, communications and water projects. Funding is needed to deliver this plan!

However, it has become clear that some of the investment for UK infrastructure projects is being sought from abroad.

Indeed, it has been reported that Number 10 has had multiple meetings in 2014 with foreign Sovereign Wealth Funds and overseas Pension Funds to discuss potential investments in British infrastructure projects.

Sadly, LGPS Funds were not invited to sit at this table – I'll come back to this later.

Since November last year:

- The Qatari sovereign wealth fund has purchased Canary Wharf

- The Chinese and Singaporeans have announced they are discussing a move to finance a bid for O2

- The Norwegians continue to invest in the Crown Estates

- A consortium of the Australian Macquarie Bank and Spanish group Ferrovial purchased Southampton, Glasgow and Aberdeen airports.

These are just a few of the headlines.

These Funds, like many others, see the returns and the quality of UK infrastructure investments. And this will continue.

LGPS Funds, and thus UK pensioners, could be benefiting from funding investments such as these.

After years of near zero interest rates, investors have been looking to real assets for return and income.

And, some of the larger players play in this field, for example, Greater Manchester's airport investment vehicle has proven to be a strong competitor.

Recently, there has also been Lancashire County Pension Fund's bid for the Government's stake in Eurostar. This is another welcome move.

However, it is telling that the media coverage decided to set the scene by mentioning that the county is better known for hotpots, cotton mills and Blackpool's pleasure beach than investment. The inference seems to be that such a fund would be out of its league with an investment of this nature. Let us be clear, this is one of the LGPS's larger funds, with a total fund to invest of £5 billion.

The fact that Lancashire County Pension Fund is going toe-to-toe with larger international funds on UK assets should be the norm, not an oddity. It should be celebrated as a step in the right direction. Both for the infrastructure that it could finance and for the UK Pensioners it provides a future for.

Pension Funds should seek to purchase infrastructure assets that produce higher yields at a time of ultra-low interest rates, sluggish growth and ongoing uncertainty.

Indeed, a recent survey of global defined benefit pension schemes suggested that more than 40% are interested in infrastructure investments.

Whilst this means it is a competitive market, LGPS Funds can offer the right projects a long-term and committed partnership in return for long-term returns that match our liabilities.

At LPFA we include real estate in our investment mix, primarily for its income stream.

The private rented sector accounts for approximately 17% of all households, or nearly 3.8 million homes in England.

And with the well-documented shortage in the UK rental housing market, institutional investors like LGPS funds could play a significant development role.

This has the potential multi-benefit of providing high quality investment opportunities at the same time as providing a much wider societal benefit.

This is not a new concept.

Institutional investment underpins the build-to-rent sector in several European countries and the United States.

For example, Hans de Ruiter, Chief Investment Officer of the Euro 2.6bn Dutch TNO Pension Plan recently said that, in a time of less stable cash flows, the income from real estate is the best match for the liability structure of their pension fund. And so it could be for us.

At this very moment, the LPFA has 65 members over the age of 100. Our liabilities stretch far into the future. Indeed, some of our current members may well be receiving pensions in the next century.

When you think about it in those terms, you realize our focus cannot just be about getting to the 7 or 8 per cent returns we are talking about here, but about taking a real long-term, strategic approach to identify and invest in quality assets.

Infrastructure investment not only provides a return over the long-term, it also provides us with a liquidity premium.

This means we essentially receive 'more for our money' because the money is committed for a longer period of time. With a detailed understanding of our liabilities and when they fall due, we are able to seek this liquidity premium safe in the knowledge that we are investing amounts that we do not need to access for some time.

Looking at the LPFA Fund specifically, examples of possible investments include operational and Greenfield projects like airport expansion or debt and equity investments.

From a sector perspective we are interested in transport, housing, commercial real estate and regulated assets such as transmission or utility companies.

We also invest through Funds, Secondaries and club deals. Investing direct is attractive as it lowers costs and gives control. However, commitment and resource is required to do this.

Larger Funds have the resources to pursue more complex liability driven investment strategies, focusing on matching future cash flows to future liabilities, hedging exposure to changes in interest rates and inflation, and offering significant additional flexibility and capital efficiency.

At the LPFA we have accrued a team of specialist investment professionals.

We believe that building our internal investment team affords us the opportunity to invest in asset classes such as infrastructure an illiquids which would otherwise be more difficult for us to access.

This strategy, along with matching our assets and liabilities while managing our costs, assists us in our long-term goal of closing the funding gap and ensuring all our pensions will be paid as and when they fall due.

It also means we are, more than ever actively managing our Fund and closely monitoring fund managers with whom we work.

But not all LGPS Funds can make this level of investment in their teams or move away from a traditional outsources investment model.

As we all know, the UK's pension fund industry is fragmented; few smaller pension funds have the resource to make major long-term investments in new roads, railways or airports.

What we face in the LGPS now is the issue of how we can build economies of scale in order to break away from **having to** invest in 'safe assets'.

As some of you will know, I am also the Chairman of the Local Capital Finance Company, which is about to be renamed the UK's Municipal Bonds Agency. This is an exciting initiative which aims to reduce local authority reliance on Treasury funding.

There are many parallels with what we now face in the LGPS. By creating a municipal bond agency, local authorities can benefit from the economies of scale of large, liquid bond issues. Through this, and joint and several guarantees, they can access much cheaper funding.

This will help local authorities to invest capital in more housing and infrastructure; which in turn will benefit local communities.

As with pension investment in infrastructure assets, Scandinavian nations have also lead the way in municipal bonds.

By working together, local authorities can benefit from the scale and lower costs of municipal bonds. Through creating such scale, the LGPS can benefit from the ability to access a wider range of infrastructure investments.

It also comes back to **reform**.

There is a growing momentum for structural change within the LGPS.

The title of today's seminar makes reference to this: "Comply or Explain; Govern or Be Governed". What is less clear is what exactly this may mean. How will we comply? What should we be explaining? In which form shall we be governed?

We are still waiting for these answers.

In the meantime, many Funds have taken it on themselves to develop in the way they see best. The growing use of shared arrangements is delivering benefits to Funds through reduced costs, increasing access to relevant expertise and improved quality.

At the LPFA we have announced both an asset and liability management partnership with Lancashire County Pension Fund and a joint infrastructure programme with Greater Manchester Pension Fund.

We are looking to invest in projects from house and road building, to commercial and mixed-use developments, or large scale regeneration works.

Amongst other things, we are looking at how we can become involved in funding projects linked to the development of the proposed high-speed rail lines between London, Birmingham, Leeds and Manchester.

At the same time, London Councils have formed a Common Investment Vehicle. I believe they are doing so for the same reasons: To achieve economies of scale, significant cost savings and to improve access to alternative assets that may be beyond each individual Fund.

There is obviously one reform that would be unhelpful.

That would be to have a single solution imposed on all pension funds. While forcing pension funds to adopt a passive investment management strategy may work for some, it would hinder others.

How could one hope to select quality assets by putting members' money into a fund and then hoping for the best?

With a trickling return less than inflation for that matter.

The answer is that you cannot.

LGPS Funds need to learn from our international peers and competitors and seize the opportunities that are presenting themselves.

I believe one of the key issues that stops the LGPS pension Funds from being at the forefront of UK infrastructure investing is that we speak with multiple different voices. But it seems we are not being heard. Be it Whitehall or the City, many are in the dark about who and what the LGPS is. As a collective, the £180bn of assets that the LGPS manage is comparable to the Singaporean Sovereign Wealth Fund and combined would be the sixth largest pension Fund in the world.

To put it simply, if a call was made tomorrow, say from No.10 seeking investment in HS2 economic growth around railway stations and LGPS Funds were asked about a potential investment deal, who would say whether collectively we might or might not be interested?

We have the collective size to be meaningful players and investors. Our local knowledge and relationships make us the perfect partners for many UK infrastructure projects. In times of low interest rates, we must find assets to invest in that provide a return that will reduce and ultimately eliminate our deficits. To do this we must be able to play on a bigger stage.

The case for a better class of investment, such as infrastructure, and smarter strategic asset allocation across the LGPS really is quite clear.

Thank you.