DRAFT RESPONSE TO DCLG CONSULTATION RE LGPS, MAY 2014

Q1. Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments ? Please explain and evidence your view.

The use of common investment vehicles (CIVs) could allow some funds, especially smaller ones, to achieve economies of scale and deliver savings. However, it should not be assumed that this will be the case in all circumstances, especially for larger funds with dedicated internal investment management resources. In Chapter 2 of the Hymans Robertson report on LGPS structure analysis, it is mentioned that internally managed funds have delivered good investment performance cost effectively (drawing on research provided by CEM).

In the case of WMPF specifically, there is a substantial internal investment team, within which there is a successful function dedicated to passive index tracking of developed quoted equities markets. The latter has been delivered at less than half of the cost than the estimates of the equivalent services as reported in Hymans Robertson's report. See Annex A for particulars of costs and performance. Note that the impact of transaction costs is reflected in the investment performance figures provided.

We believe that WMPF's ability to deliver a relatively cost effective index tracking service reflects its bespoke nature for a sizeable pool of assets (£2.6 billion under direct management as at 31 March 2014). External service providers need to have a substantial supporting infrastructure (to support business development and multiple clients) and to generate profits for shareholders. For WMPF, there are also no regulatory, set up and running costs associated with a CIV or a similar vehicle.

WMPF would be open to discussion regarding the provision of its service to other LGPS funds (whether via a CIV or other arrangements) but the regulatory, resourcing, risk and costing implications would need to be assessed to establish whether such an arrangement is worthwhile.

WMPF recognises the advantages of scale for the passive management of highly liquid investments such as quoted equities in developed markets and gilts (both conventional and index linked). In other areas, whilst some scale and resources are essential, the deployment and management of capital needs to be handled effectively, especially in less liquid assets and strategies. Scale per se does not necessarily lead to optimal investment outcomes.

Q2. Do you agree with the proposal to keep decisions about asset allocation with the local authorities ?

Yes. WMPF supports the key principle of local accountability. If other important decisions are made locally, it makes sense that asset allocation decisions are made locally, too.

Decisions on asset allocation need to be made in the context of fund objectives, cashflows, liabilities, contribution rates, deficits, deficit recovery plans, portfolio risks, employer covenant strength and other relevant factors.

Asset allocation decisions are by far the most important determinants of long term investment performance and risk – far more so than, say, the decision to appoint fund manager A or fund manager B for a given mandate.

If asset allocation decisions are made locally, it makes sense for decisions regarding portfolio objectives and portfolio construction to be made locally too, as these are crucial as well as integral to the overall investment process. These would include decisions on how much to invest passively and how much to invest actively in liquid assets. They would also include making decisions on whether or not to invest in alternative assets and if so, for what reason (s) and in which areas.

WMPF recognises the importance of effective governance and appropriate resourcing wherever decisions are made. It has a dedicated trustee training programme for all committee members and a substantial internal investment division supported by external advisers. Intuitively it makes sense that good governance leads to better outcomes and there is some evidence (for example in Dyck and Pomorski's paper 'Is bigger better? Size and performance in Pension Plan Management') that this is so, too. It also underlines WMPF's belief in having dedicated internal investment management resources to support committee members.

Q3. How many common investment vehicles should be established and which asset classes do you think should be represented in each of the listed asset and alternative common investment vehicles ?

WMPF is open minded about the use of CIVs and is in favour of other methods of collaboration (see below). At this stage we would not support mandatory use of CIVs. Nor would we wish to be prescriptive regarding the specific number of CIVs. We agree that funds of funds are expensive and do not support their extensive use.

When considering how many CIVs are established, it is important to recognise that in actively managed and less liquid areas, big is not necessarily better. CIVs should be sized and structured so that capacity is managed carefully to ensure that investment objectives are delivered effectively.

Whilst the case for investing in alternative investments via a CIV or CIVs is intuitively strong, it is a more complex area than conventional liquid assets and the practical issues associated with successfully setting up such a vehicle should not be underestimated. For incoming investors, there would need to be clarity regarding investment objectives and terms. The liquidity and diversification characteristics would need to be considered, too.

In one important alternative asset class, infrastructure, WMPF is a founding member of the Pensions Infrastructure Platform (PIP) and is committed to supporting PIP along with certain other LGPS and corporate pension funds. This is a cost effective way of investing in infrastructure compared with alternative approaches.

In addition or as an alternative to investing via CIVs, consideration should be given also to other methods of collaboration. WMPF highlights the National LGPS Frameworks, which seek to reduce procurement costs and timescales as well as delivering cost effective solutions. Greater use of pooled funds specifically designed for LGPS funds and hosted by investment managers may also deliver meaningful cost savings quickly and simply. We believe it very likely that greater use of both options could deliver results more quickly than setting up CIVs.

WMPF is fully supportive of collaborative ventures involving other LGPS funds in order to achieve efficient and cost effective outcomes. In addition to PIP, WMPF is a founding member of the Investing for Growth initiative along with several other large LGPS funds. This initiative seeks to identify suitable investment opportunities that have a positive economic and social impact in the UK and its regions. WMPF would be very open to discussion on collaboration in other areas, too.

Q4. What type of common investment vehicle do you believe would offer the most beneficial structure ? What governance arrangements should be established ?

So far as CIVs specifically are concerned, the following characteristics are crucial –

*Robust governance structure and arrangements (covered later in this section)
*Appropriate for professional investors to pool assets
*Capable of supporting a range of ring fenced sub funds
*Flexible for different investment strategies
*Cost efficient
*Manageable capital considerations
*Appropriately regulated

*Assets held by an appropriate custodian
*Able to be used as part of a master/feeder arrangement
*Capable of offering a range of liquidity options for investors
*Tax efficient with regard to both capital gains and other taxes
*Access to dual tax treaties so that withholding taxes are minimised
*Cost and tax efficient in specie transfer of assets into the vehicle

In this regard, regulated co-ownership tax transparent pension fund vehicles could be particularly appropriate. The CIV currently being set up by certain London Boroughs could be regarded as a valuable pilot. It may be prudent to defer the setting up of any new CIVs until after the London CIV is successfully up and running in order to benefit fully from the experience of creating this vehicle.

WMPF suggests that the associated governance arrangements should be robust and kept as simple and straight forward as possible. Key areas of focus should be on improving net returns (with due regard to risk), reducing / controlling costs, addressing conflicts of interest and facilitating decision making for the funds that invest in any CIVs.

In order to strengthen governance and oversight, it is suggested that any CIV should have an investment committee with membership drawn from fund officers and members with support from professional advisers.

Q5. In the light of the evidence on the relative costs and benefits of active and passive management, including Hymans Robertson's evidence on aggregate performance , which of the options set out above offers best value for taxpayers, Scheme members and employers ?

WMPF highlights its belief, as evidenced in Chapter 2 of Hymans Robertson's report on LGPS structure analysis, that internally managed funds can and do deliver good investment performance cost effectively. Accordingly, we think that this option offers best value.

On the issue of passive investment, with a total of £3.6 billion of its listed assets invested passively, WMPF believes that passive index tracking has a crucial role to play in the effective management of developed market listed equities and gilts (conventional and index linked). We have found that the successful deployment of significant funds with active fund managers is very difficult in some areas – large cap listed UK and US equities and gilts. Passive index tracking management in these areas is an effective, low cost way of deploying substantial amounts of capital.

At the same time, WMPF favours targeted active fund management in listed assets. In some areas we have had success in identifying and accessing active fund managers who have added value after fees and other costs. In global equities, the

Fund’s active fund managers have generated added value of 1.2% per annum over the last three years. In emerging markets equities, we have recently put new fund management arrangements into place employing three active fund managers who we believe will add long term value whilst managing portfolios with significantly lower volatility than investing via a market capitalisation index in what is an intrinsically volatile asset class.

In some areas, we think that the deployment of passive index tracking is sub optimal. A passively managed allocation to corporate bonds tracking a market capitalisation benchmark would structurally expose investors to the more indebted and therefore intrinsically higher risk issuers. We would not support its deployment as an effective way of investing in this asset class.

WMPF firmly believes that both passive and active management options (including options that could be categorised as either, for instance ‘smart beta’) should be considered in the process of setting objectives for portfolios both individual and consolidated. Issues to consider include not only returns, costs and value for money (all crucially important) but also portfolio volatility, risks (for instance concentration risks) and overall portfolio construction.

Of the four options presented, WMPF favours the ‘comply or explain’ one as offering potentially the best value, as long as the process for so doing takes proper account of funds’ specific investment objectives and genuinely assesses long term performance (recognising that over short term timescales, the most successful active managers can and do underperform).

We fully accept that rigour is needed in determining the decision to invest passively or actively in listed assets but do not believe that compulsion to invest passively (in whole or part) would be a solution to improve investment performance cost effectively. Accordingly, we do not favour the first two options proposed. The fourth option, which amounts to the status quo, is in our view insufficiently rigorous.

Summary

WMPF firmly supports appropriate measures to improve the efficiency and cost effectiveness of the LGPS. So far as the consultation is concerned, we consider that -

- LGPS internal investment management arrangements deliver good investment performance cost effectively as is evidenced in Hymans Robertson’s report. They should be encouraged and supported as far as practicable ;

- Decisions regarding asset allocation and portfolio objectives should be made locally;
- All forms of collaboration should be actively explored. There may be a role for a CIV or CIVs (ie in alternative investments) but we would not support the mandatory use of CIVs and the potential complexities associated in setting up such a vehicle should not be underestimated;
- The 'comply or explain' option would be best so far as passive investment management is concerned. WMPF believes that passive investment management has a crucial role to play in listed assets, but in conjunction with targeted active investment management. WMPF does not favour compulsion to invest passively (in whole or part) as an optimal solution.

12 June 2014.