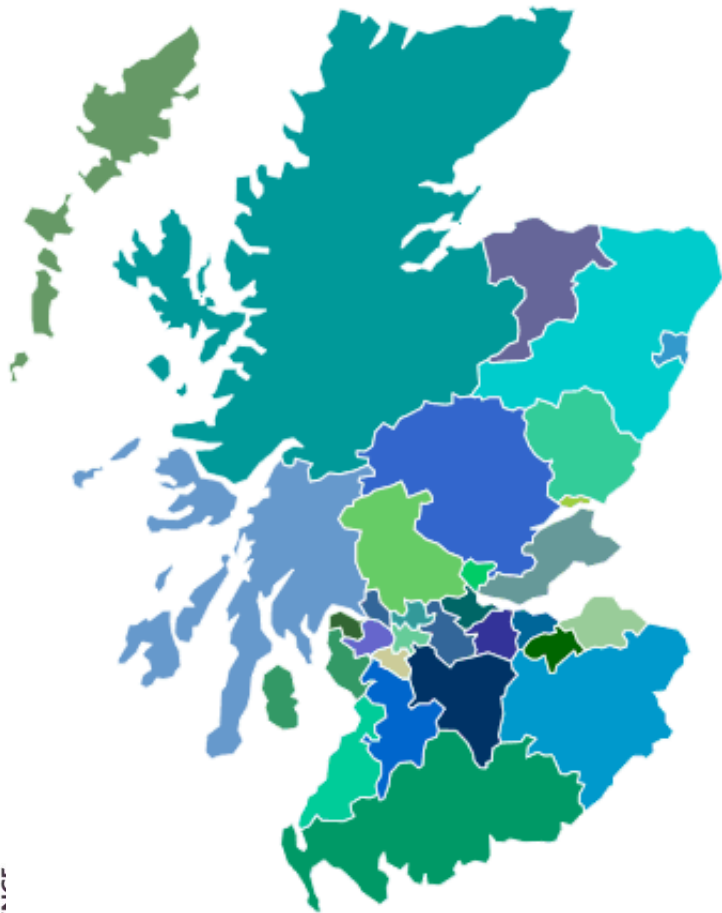




Consultation on Structure

Scottish LGPS



11 Funds in Scotland:

- Total c£46bn (June 2018), 400,000 members
- Largest: Strathclyde Pension Fund c£23bn
- Smallest: Orkney Islands c£400m
- Lothian, 2nd largest c£7bn

Background to The Consultation

- 2013 Heads of Agreement between COSLA and trade unions
- Scheme Advisory Board preparatory work – working group, Mercer analysis, academic paper
- Cabinet Secretary requested consultation

Background to the Consultation

- Prior reviews in Scotland by Deloitte & Hymans Robertson
- Enforced investment pooling in England and Wales

The Consultation

- Four options
 - Status quo
 - Greater collaboration
 - Investment pooling
 - Merger
- Deadline for response: 7 December 2018
- Pensions Institute analysing responses
- SAB recommendation to Minister

LPF's response

- Committee & Board workshop: 5 Sept
 - Agree interim response: 26 Sept
 - Stakeholder engagement: Oct & Nov
 - Agree final response: 12 December
- (Subject to agreement with SAB/Pensions Institute)*

Pension Board response?

Principles/Assumptions

- Fiduciary duty – invest in best interests of members and employers
- Investment is a scale business
- Current structure would not be designed from scratch
- **GOVERNANCE IS KEY!**

There are significant vested interests.

*LPF's response focuses on the best interests
of members and employers*

Agenda

- The Current Structure
- Collaboration
- Pooling
- Merger
- Feedback

- Multi-Fund employers

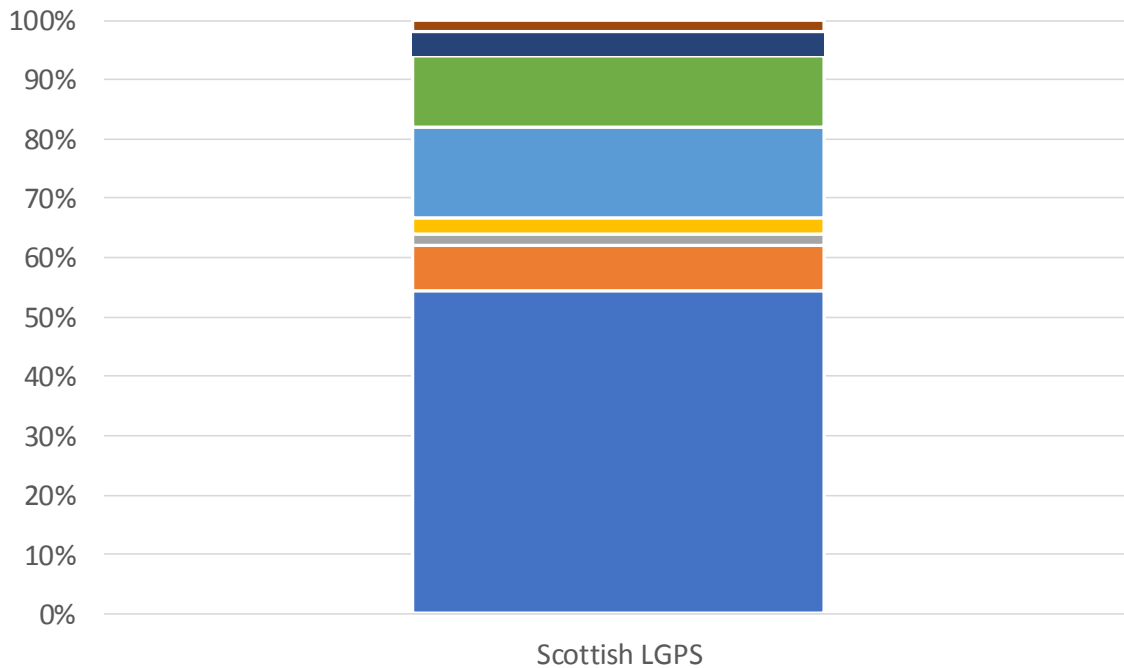
Scottish LGPS

Current Structure

Investment Strategy

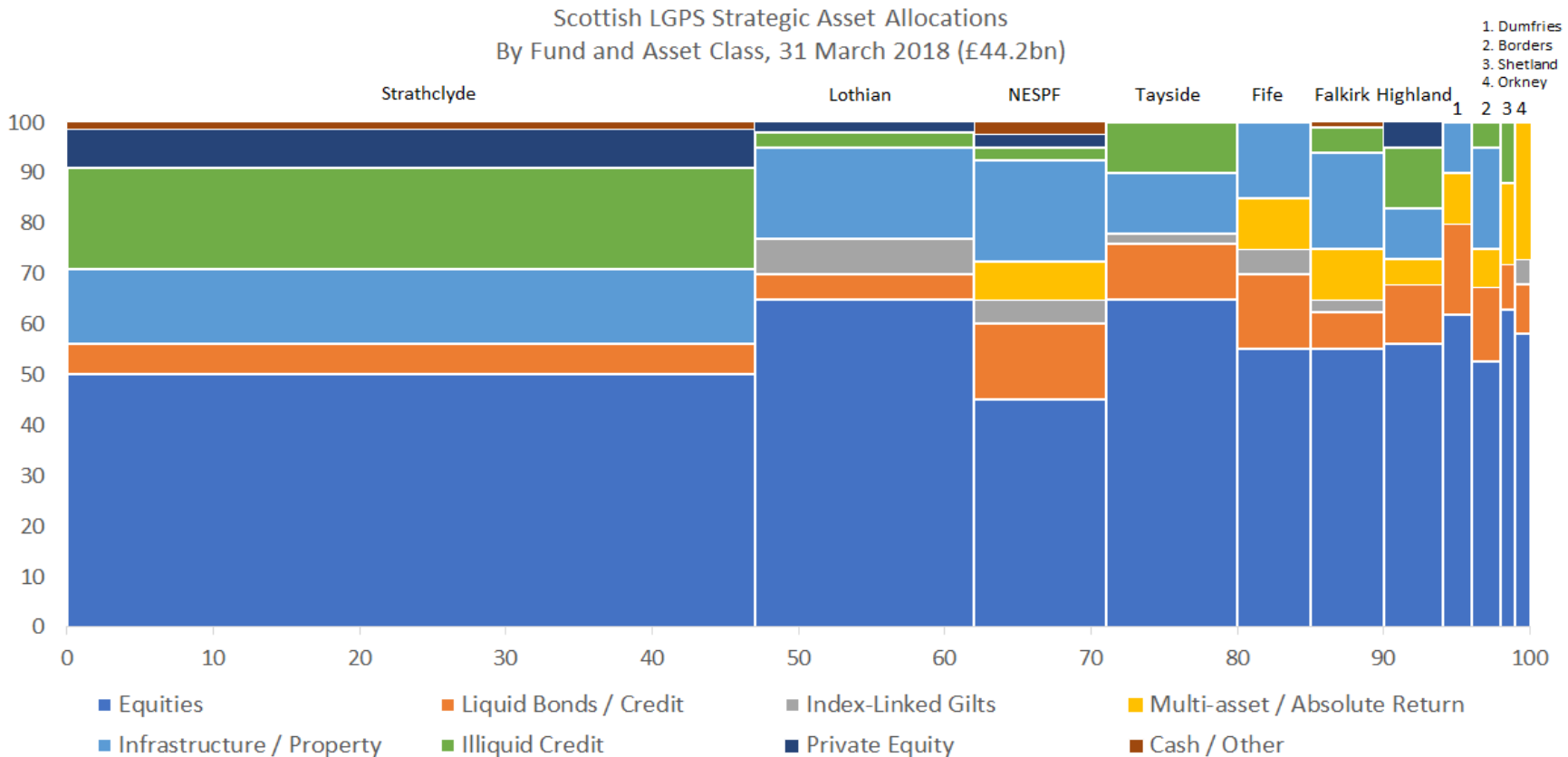
SLGPS Summary

Scottish LGPS Strategic Asset Allocation
By Asset Class, 31 March 2018 (£44.2bn)



- Equities are the largest allocation (c55%), followed by infrastructure/property (c15%)
- c66% are liquid assets (equities, bonds/credit, etc)
- “Day 1” merger transition costs could be minimal; any changes could be phased over time

Investment Strategy By Fund



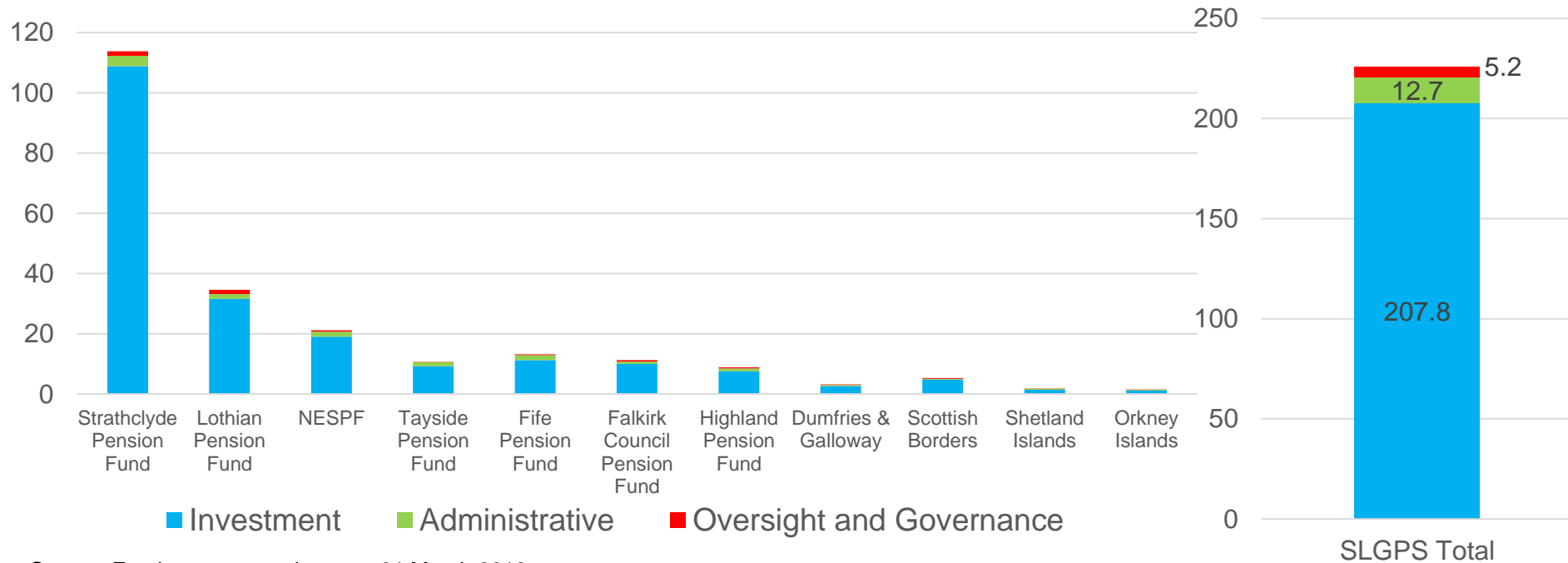
Source: Fund accounts and reports 31 March 2018, LPF analysis

- 6 funds comprise 90% of all SLGPS assets
- Overall asset allocation dominated by equities
- Asset categories and reporting varies across funds; where required, allocations have been re-categorised for consistency

Management Costs By Fund and SLGPS Total

SLGPS Management Expenses (£m)
12 months to 31 March 2018

SLGPS Total
£225.6m



Source: Fund accounts and reports 31 March 2018

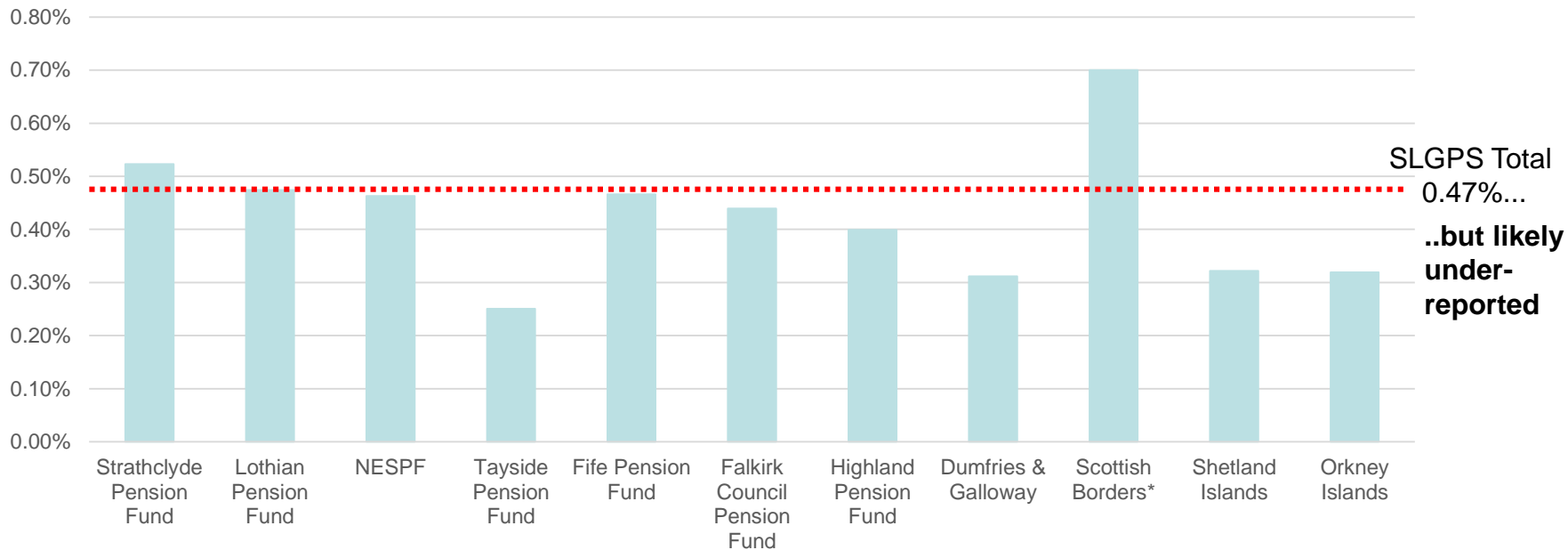
- Reported management expenses of c£225m
- **Investment expenses dominate – 92% of total (c£208m)**
- Cost reporting/transparency varies across funds
- Total investment costs likely to be under-reported (e.g. underlying costs within Fund of Funds)



Investment Expense Ratios

By Fund and SLGPS Total

SLGPS Investment Expenses (as % of Assets)
12 months to 31 March 2018



Source: Fund accounts and reports 31 March 2018

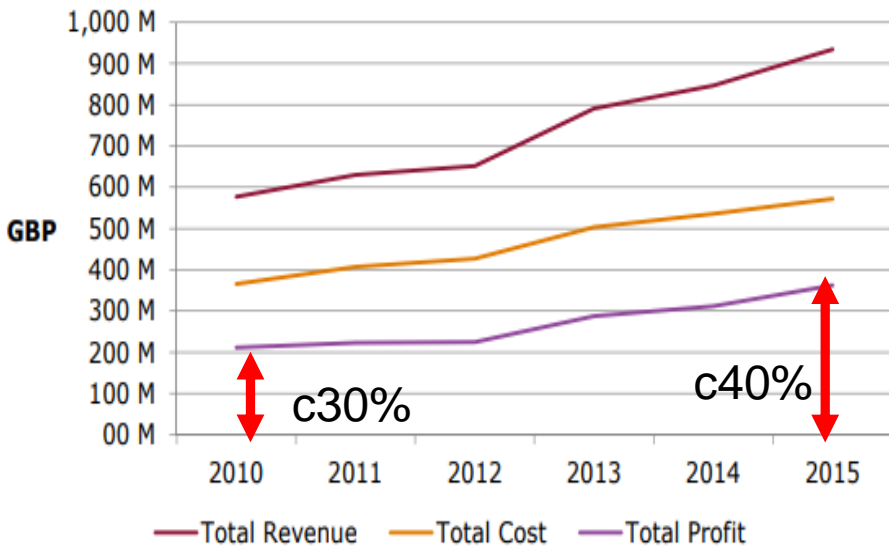
Note: Scottish Borders* expense ratio excludes £3.4m one-off transaction costs

- Declared SLGPS investment expense ratio is 0.47% (c£208m)
- External asset management fees are the largest component
- **CIPFA guidance does not require underlying Fund-of-Fund costs to be included** (these are included for Lothian, increasing the expense ratio from 0.39% to 0.47%)
- **Investment costs are therefore likely to be under-reported**

Investment Expenses

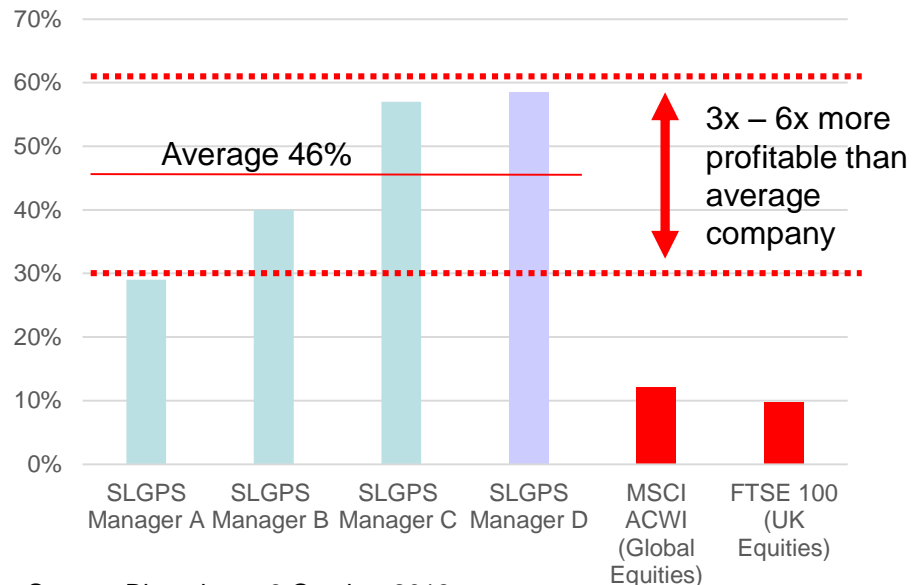
Asset manager profitability

Figure 2: Average of total revenue, cost and operational profit



Source: FCA Asset Management Market Study Interim Report (Nov 2016) - Annex 8, pg 9

Operating Profit Margins
12 months to 30 June 2018

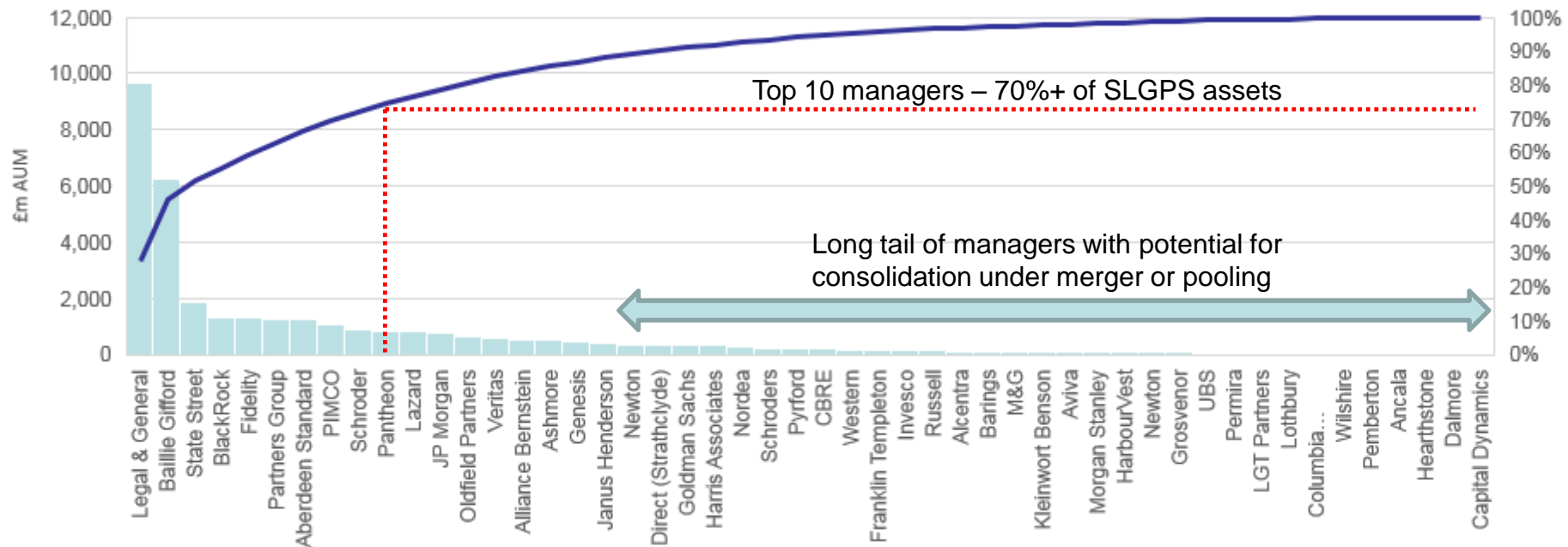


Source: Bloomberg, 9 October 2018

- 2016 FCA study indicated asset manager profit margins of c30%-40%
- Reported 2018 margins for 4 out of the top 10 SLGPS managers reinforce FCA results
 - Margins ranged from c30% - c60%, averaging 46%
 - The highest margin manager (c58% in blue) manages passive mandates
- Assuming fees of £200m, average margin 46% => **profits from SLGPS fees of £92m**

External Asset Managers

SLGPS Assets (AUM) by manager, 31 March 2018

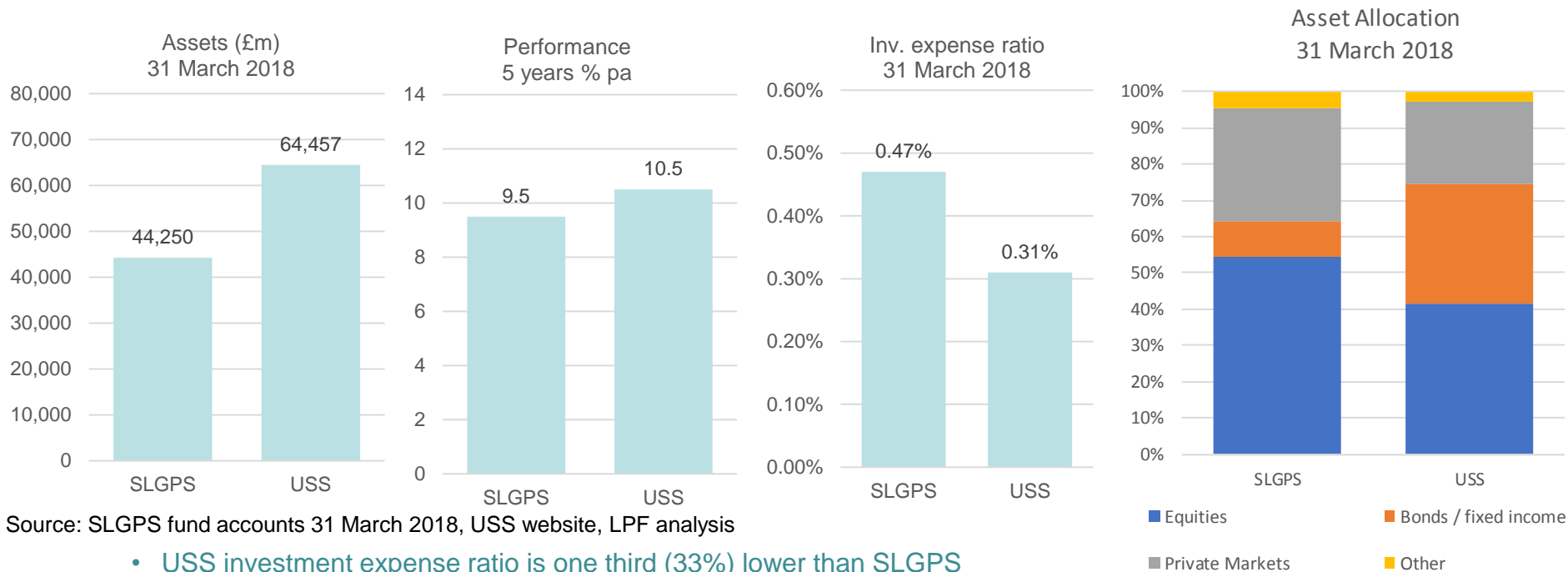


Source: Fund accounts and reports 31 March 2018, LPF analysis

- **Overly concentrated?** Two managers - L&G and Baillie Gifford – account for c£16bn, almost 50% of external SLGPS AUM. The top 10 managers (£25bn) represent 70%+.
- **Over-diversification?** At least 52 external managers were identified from SLGPS reports; this under-reports the total SLGPS manager figure as private markets allocations (which may have multiple managers) are not all included. The long tail has potential for consolidation (with fee and governance savings) under merger.
- Merger represents a threat to some managers - potential for lower fees (reduced mandate size and/or number); some managers are therefore conflicted and will not support merger or pooling.

Whole of Fund Comparison SLGPS and USS

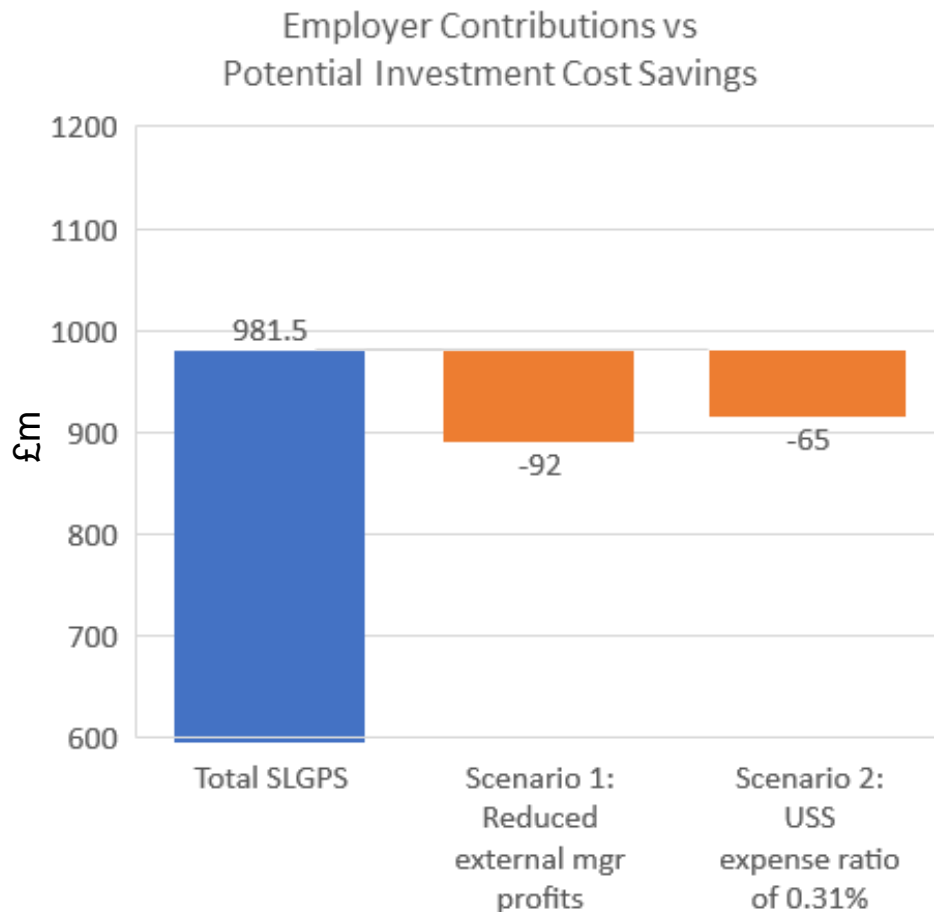
- Universities Superannuation Scheme - established 1975, in-house team est. 1981, FCA authorisation received 2012
- £63.6 billion in assets, over 418,000 DB members across 350+ institutions
- c75% of USS assets are managed in-house (vs estimated c14% for SLGPS)



- USS investment expense ratio is one third (33%) lower than SLGPS
- In-house management (75% of AUM) is a major contributor to lower USS expenses
- Greater use of external managers (30-40%+ profit margins) contributes to higher SLGPS expenses
- If SLGPS achieved USS expense ratio of 0.31% on investment costs of £208m, **estimated savings would be c£65m p.a.**

Employer Contributions

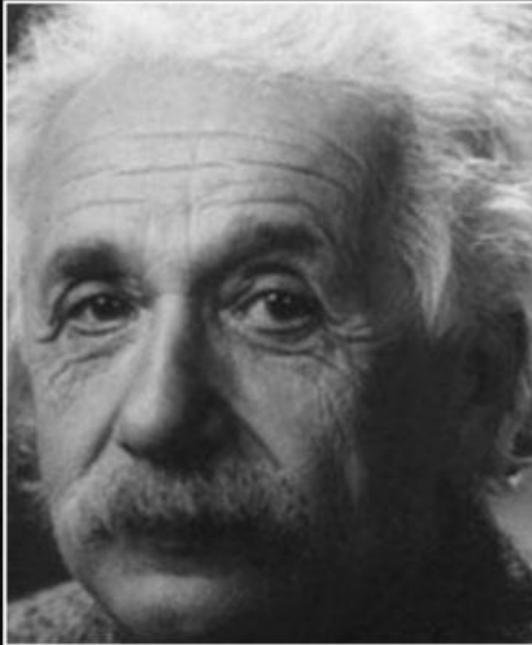
Potential savings of 7% - 10% per annum



- Total SLGPS employer contributions for the 11 main funds over the 12 months to 31 March 2018 were c£982m.
- Scenario 1: Our previous analysis showed SLGPS external manager profits of £92m. Reducing these (e.g. through in-house management or lower fees) **could reduce annual employer contributions by up to 9%.**
- Scenario 2: achieving the USS expense ratio of 0.31% showed the potential for savings of c£65m, **which would reduce annual employer contributions by c7%.**
- Potential savings may be meaningfully greater if SLGPS investment costs are under-reported, as seems likely.
- Our estimate of the potential savings from more efficient investment implementation is **in the range of 7% - 10% of employer contributions per annum (equivalent to £65m - £100m p.a.)**

Fee Savings

Compound interest and long term impact



Compound interest is the eighth wonder of the world. He who understands it, earns it... he who doesn't... pays it.

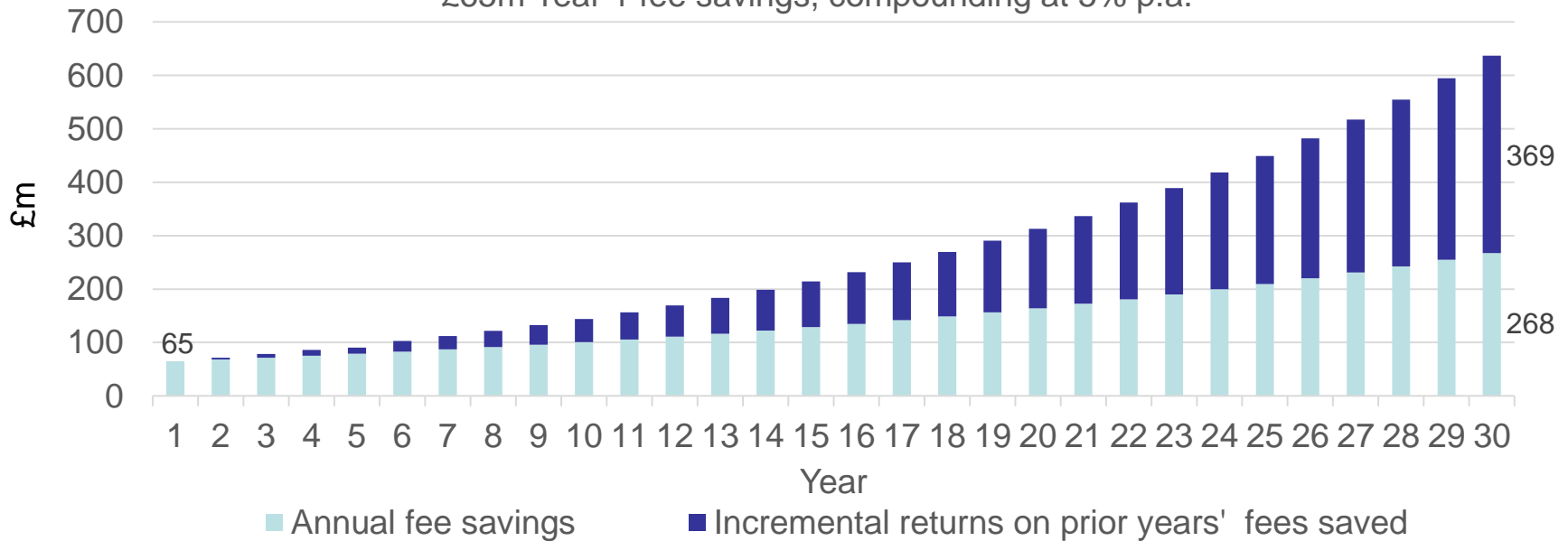
— *Albert Einstein* —

- The SLGPS funds are for the long term; at a minimum, we expect the SLGPS to be providing benefits to members for at least the next 30 – 40 years.
- Estimated cost savings of £65m - £100m pa over the long term would deliver not only the annual fee saving, but also an **incremental return** on the fees saved – the savings are available to generate an investment return, which would **compound** over time.
- The following two slides illustrate the fee saving and the incremental return...

Fee Savings

Compound interest and long term impact

Annual Fee Savings and Incremental Returns
£65m Year 1 fee savings, compounding at 5% p.a.



- Year 1 fee savings are £65m; assets grow at 5% per annum; all subsequent years also benefit from incremental returns on prior year fee savings (compounded at 5% per annum)
- By year 30, the incremental return from compounding 29 years of prior year fee savings amounts to £369m – more than the annual fee saving of £268m at year 30. **Total benefit = £637m**

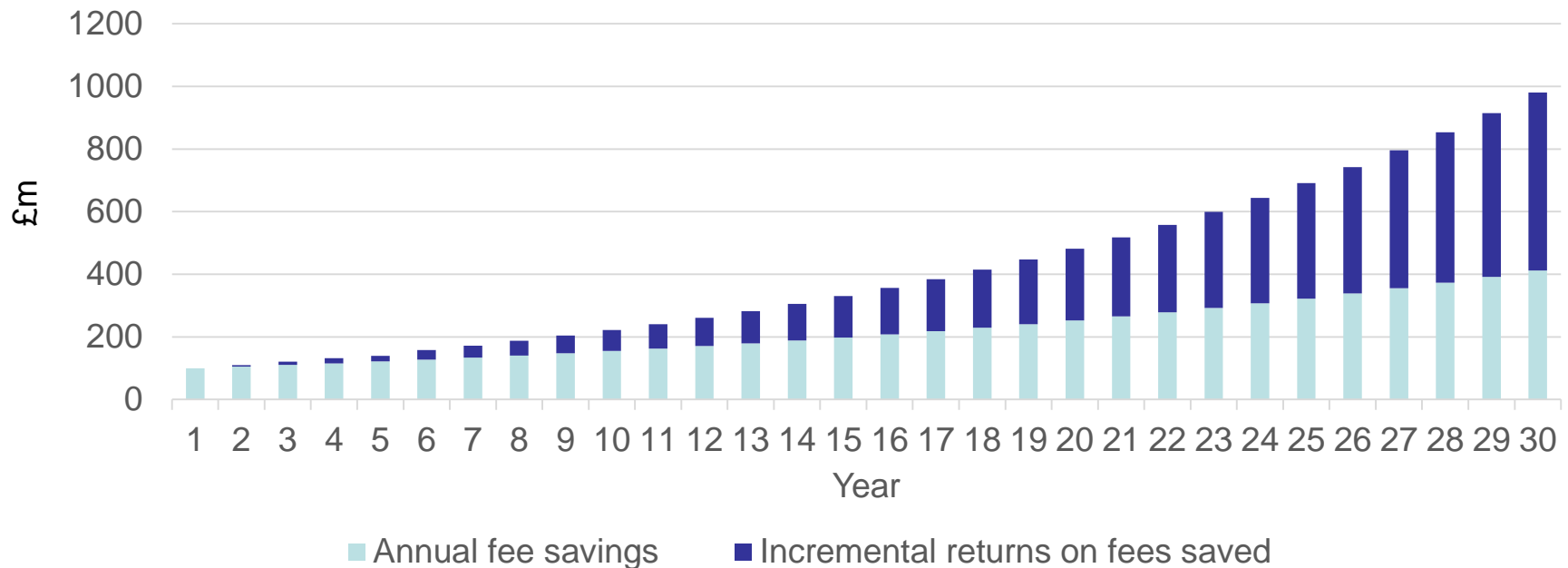
30 year cumulative fee savings and incremental returns amount to £8bn



Fee savings

Compound interest and long term impact

Annual Fee Savings and Incremental Returns
 £100m Year 1 fee savings, compounding at 5% p.a.



- Year 1 fee savings are £100m; assets grow at 5% per annum - by year 30, the combined benefit of annual fee savings and compounding of incremental returns on savings is **almost £1bn**

30 year cumulative fee savings and incremental returns amount to £12.3bn

Governance

Pensions Committees and Boards

Fund	Pensions Committee			Pensions Board	Other Employers
	Admin. Auth. Councillors	Other Employers	Employee / Members	No. of Members	
Strathclyde	8			8	180
Lothian	5	1	1	10	90+
North East Scotland	9			8	53
Tayside	6			8	45
Fife*	9	2*	2*	8	30
Falkirk	6	1	2	8	35
Highland	11			8	30+
Dumfries & G	10			8	13
Borders	7			8	18
Shetland	10			8	13
Orkney	7			8	9
TOTAL	88	4	5	90	516+

- Committee composition varies across funds, with limited representation from other employers and employees/members
- Significant annual governance burden across SLGPS – 180+ individuals

Source: Fund accounts and reports 31 March 2018

Note: Fife* non-Councillor Committee positions are non-voting

Collaboration

Pooling

Merger

Feedback

Multi-fund employers

Issues faced by multi-fund employers

Administration

- Different forms/timescales/processes
- Employers have already consolidated

Funding

- Different actuaries/methodologies

Communications

- Timing and format
- LGPS 2018 issues

Anything else?

Consolidation of assets and liabilities?

Schedule 4, Part 1 of the LGPS (Scotland) Regulations 2018:

2. This paragraph applies where a **Scheme employer**-
 - (a) has members in respect of whom, but for this paragraph, it would be required to contribute to more than one fund;
 - (b) merges or amalgamates with another **Scheme employer** and in respect of which there is specified a different fund for the respective members of each **Scheme employer**; or
 - (c) moves its main place of business to a different geographical area.
3. Where paragraph 2 applies, the Scottish Ministers may, upon application of the **Scheme employer**, by direction substitute another fund ("the substituted fund").
4. Before giving a direction under paragraph 3 Scottish Ministers must consult with any bodies appearing to them to be affected by the proposed direction.
5. The direction may require the making of financial adjustments between the funds, whether by way of a payment to the substituted fund or of a transfer of assets or both.



Consultation on Structure